

Audit

Report



INTERNAL CONTROLS AND COMPLIANCE WITH LAWS AND
REGULATIONS FOR THE DEFENSE LOGISTICS AGENCY
WORKING CAPITAL FUND FINANCIAL STATEMENTS
FOR FY 1998

Report Number 99-089

March 1, 1999

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Inspector General, Department of Defense
400 Army Navy Drive (Room 801)
Arlington, VA 22202-2884

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Acronyms

DFAS	Defense Finance and Accounting Service
DLA	Defense Logistics Agency
IG	Inspector General
OMB	Office of Management and Budget
WCF	Working Capital Fund



INSPECTOR GENERAL
DEPARTMENT OF DEFENSE
400 ARMY NAVY DRIVE
ARLINGTON, VIRGINIA 22202

March 1, 1999

MEMORANDUM FOR UNDER SECRETARY OF DEFENSE (COMPTROLLER)
AND CHIEF FINANCIAL OFFICER
DIRECTOR, DEFENSE FINANCE AND ACCOUNTING
SERVICE
DIRECTOR, DEFENSE LOGISTICS AGENCY

SUBJECT: Audit Report on Internal Controls and Compliance With Laws and
Regulations for the Defense Logistics Agency Working Capital Fund
Financial Statements for FY 1998 (Report No 99-089)

We are providing this final report for information and use. We considered comments from the Defense Logistics Agency on a draft of this report in preparing the final report. The Chief Financial Officers Act of 1990, as amended by the Federal Financial Management Act of 1994, requires financial statement audits by the Inspectors General. We conducted this audit in accordance with the requirements of Office of Management and Budget Bulletin No. 98-08, "Audit Requirements for Federal Financial Statements," August 24, 1998, as amended January 25, 1999. This bulletin requires the Inspector General, DoD, to render an opinion on the Defense Logistics Agency Working Capital Fund financial statements and to report on the adequacy of internal controls and compliance with laws and regulations.

We were unable to render an opinion on the Defense Logistics Agency Working Capital Fund Financial Statements for FY 1998 because of continued deficiencies in accounting systems and control procedures. Therefore, we issued a disclaimer of opinion on the FY 1998 Defense Logistics Agency Working Capital Fund Financial Statements. Our disclaimer of opinion is included in Exhibit 3.

We appreciate the courtesies extended to the audit staff. Questions on the audit should be directed to Mr. James L. Kornides, at (614) 751-1400 extension 11, (jkornides@dodig.osd.mil) or Mr. Timothy F. Soltis, at (614) 751-1400 extension 13, (tsoltis@dodig.osd.mil). See Appendix C for the report distribution. A list of audit team members is inside the back cover.

David K. Steensma

David K. Steensma
Deputy Assistant Inspector General
for Auditing

Office of the Inspector General, DoD

Report No. 99-089
(Project No 9FJ-2005.03)

March 1, 1999

Internal Controls and Compliance With Laws and Regulations for the Defense Logistics Agency Working Capital Fund Financial Statements for FY 1998

Executive Summary

Introduction. Public Law 101-576, the "Chief Financial Officers Act of 1990," as amended by Public Law 103-356, the "Federal Financial Management Act of 1994," requires financial statement audits by the Inspector General, DoD, and prescribes the responsibilities of management and the auditors with regard to financial statements, internal controls, and compliance with laws and regulations. The Defense Logistics Agency (DLA) and the Defense Finance and Accounting Service (DFAS) are responsible for establishing and maintaining adequate internal controls and for complying with laws and regulations applicable to DLA financial accounting and reporting. Our responsibility is to render an opinion on the financial statements based on our work, and to determine whether internal controls were adequate and whether management complied with applicable laws and regulations.

Audit Objectives. The overall objective of our audit was to determine whether the DLA Working Capital Fund Financial Statements for FY 1998 were presented fairly and in accordance with Office of Management and Budget Bulletin No. 97-01, "Form and Content of Agency Financial Statements," October 16, 1996, as amended on November 20, 1998. We also performed tests of internal controls and compliance with laws and regulations.

Disclaimer of Opinion. DLA and DFAS were not able to correct previously reported material deficiencies in inventory sampling, Fund Balance with Treasury, and Property, Plant, and Equipment. These problems materially affected the information in the DLA FY 1998 financial statements. Although DLA and DFAS were taking action to correct the problems, their actions were not completed in FY 1998. Additionally, the process for providing information to us to audit was inefficient and was adversely affected by the ability of DoD to publish guidance on the form and content of the financial statements in a timely manner. Therefore, we only performed sufficient work to determine the status of previously reported problems. We also performed limited tests of the internal controls and compliance with laws and regulations. These tests identified additional details about some of the significant problems that hampered DLA and DFAS from preparing reliable financial statements. As a result, we do not express an opinion on the FY 1998 financial statements of the DLA Working Capital Fund.

Internal Controls. We identified internal control weaknesses related to the accounting systems and the overall process used to compile information for the financial statements. In addition, there were internal control weaknesses related to DLA inventory record accuracy; inventory valuation; property, plant, and equipment; and cash collections and disbursements. Our limited review of the internal controls over financial reporting did not disclose all matters in the internal controls over financial reporting that might be considered reportable conditions.

Compliance With Laws and Regulations. We identified instances of potential noncompliance with laws and regulations related to the Chief Financial Officers Act, Federal Financial Management Improvement Act, and Statements of Federal Financial Accounting Standards. Our limited review of the compliance with laws and regulations did not disclose all instances of potential noncompliance with laws and regulations that may be considered material to the financial statements of the DLA Working Capital Fund.

Management Comments. We provided a draft of this report to DLA in accordance with Office of Management and Budget Bulletin No. 98-08. We received comments from the Chief, Financial Policy and Managerial Accounting, Office of the Comptroller, DLA. The Chief indicated that DLA is committed to improving its financial reporting. The Chief stated that DLA has developed plans of actions and specific milestones to address reporting deficiencies, particularly in reporting property, plant and equipment, sampling and valuing inventory, complying with financial reporting guidelines for systems, and implementing additional controls to improve financial reporting. The Chief also stated that, during FY 1999, DLA will participate with the Department in identifying additional strategies to improve financial reporting and will implement and report on the DoD implementation strategies that have been issued to date. The complete text of management comments is in Appendix D.

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Introduction

Background

Reporting Requirements. This audit was performed as part of our effort to meet the requirements of Public Law 101-576, the "Chief Financial Officers Act of 1990," November 15, 1990, as amended by Public Law 103-356, the "Federal Financial Management Act of 1994," October 13, 1994. The legislation requires financial statement audits by the Inspector General (IG), DoD, and prescribes management's responsibilities, auditors' responsibilities, and requires internal controls and compliance with laws and regulations. Office of Management and Budget (OMB) Bulletin No. 98-08, "Audit Requirements for Federal Financial Statements," August 24, 1998, as amended January 25, 1999, establishes the minimum requirements for audits of Federal financial statements.

Accounting Functions and Responsibilities. The Defense Logistics Agency (DLA) is responsible for providing information to the Defense Finance and Accounting Service (DFAS). DFAS performs accounting functions and compiles the DLA Working Capital Fund (WCF) financial statements. In addition, DLA and DFAS are responsible for establishing and maintaining adequate internal controls and for complying with laws and regulations that govern DLA financial accounting and reporting.

Internal Control Responsibilities. Establishing and maintaining internal controls appropriate to the entity is an important management responsibility. The objectives of internal controls are to provide management with reasonable, but not absolute, assurance that:

- transactions are properly recorded and accounted for to permit the preparation of reliable financial statements and to maintain accountability over assets;
- funds, property, and other assets are safeguarded against waste, loss, unauthorized use, and misappropriation; and
- transactions, including those related to obligations and costs, are executed in compliance with laws and regulations that could have a direct and material effect on the financial statements, and with any laws and regulations that OMB, DoD, or the IG, DoD, identified as significant and for which compliance can be objectively measured and evaluated.

Because of the immense size and complexity of the DLA WCF, automated systems are used extensively to carry out the WCF programs, manage resources, and prepare the financial statements. Accordingly, the design and controls embedded in critical automated systems directly affect the overall control structure and the ability of DLA and DFAS to comply with applicable laws and regulations.

Accounting Policy. The DLA WCF Consolidated Financial Statements for FY 1998 should have been prepared in accordance with Federal Accounting Standards and the OMB Bulletin No. 97-01, "Form and Content of Agency Financial Statements," October 16, 1996, as amended on November 20, 1998. Footnote 1 of the DLA WCF Financial Statements discusses the significant accounting policies used to prepare the financial statements.

Disclaimer of Opinion. DLA and DFAS were not able to correct previously reported material deficiencies in Inventory sampling, Fund Balance with Treasury, and Property, Plant, and Equipment. These problems materially affected the information in the DLA FY 1998 financial statements. Although DLA and DFAS were taking action to correct the problems, their actions were not completed in FY 1998. Additionally, the process for providing information to us to audit was inefficient and also was adversely affected by the ability of DoD to publish guidance on the form and content of the financial statements in a timely manner. Therefore, we only performed sufficient work to determine the status of previously reported problems. We also performed limited tests of the internal controls and compliance with laws and regulations. These tests identified additional details about some of the significant problems that hampered DLA and DFAS from preparing reliable financial statements. As a result, we do not express an opinion on the FY 1998 financial statements of the DLA Working Capital Fund.

Defense Logistics Agency Working Capital Fund. The DLA WCF provides supply support and logistics services to U.S. military forces worldwide. The DLA WCF finances five active business activity groups, located at hundreds of sites throughout the U.S. and overseas, which encompass supply management, distribution depots, reutilization and marketing offices, information services, and automated printing services. The FY 1998 Consolidated Financial Statements of the DLA WCF reported assets of \$12.7 billion and liabilities of \$1.8 billion.

Objectives

The overall audit objective was to determine whether the DLA WCF Financial Statements for FY 1998 were prepared in accordance with OMB Bulletin No. 97-01, "Form and Content of Agency Financial Statements," October 16, 1996, as amended on November 20, 1998. We determined whether internal controls were adequate to ensure that the DLA WCF Financial Statements were free of material error. We also assessed compliance with laws and regulations for transactions and events that had a direct and material effect on the financial statements.

Review of Internal Controls

Internal Control Elements

Internal Control Components. Statement on Auditing Standards No. 78, "Consideration of Internal Control in a Financial Statement Audit: An Amendment to Statement of Auditing Standard No. 55," revises the definition and description of internal control contained in Statement of Auditing Standard No. 55. Statement of Auditing Standard No. 78 defines internal control as a process affected by an entity's senior management or other personnel designed to provide reasonable assurance regarding the achievement of objectives pertaining to reliability of financial reporting, effectiveness and efficiency of operations, and compliance with applicable laws and regulations.

Internal controls consist of five interrelated components:

- control environment;
- risk assessment;
- control activities;
- information and communication; and
- monitoring.

Control Environment. The control environment includes factors that set the tone of an organization, influencing the control consciousness of its people. The control environment includes seven factors:

- integrity and ethical values,
- commitment to competence,
- human resource policies and practices,
- assignment of authority and responsibility,
- management's philosophy and operating style,
- board of directors or audit committee participation, and
- organizational structure

Risk Assessment. For financial reporting purposes, an entity's risk assessment is its identification, analysis, and management of risks relevant to the preparation of financial statements following generally accepted accounting principals (or some other comprehensive basis of accounting). The following are considered risks that may affect an entity's ability to properly record, process, summarize, and report financial data:

- changes in the operating environment;
- new personnel;

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- new information systems;
 - rapid growth;
 - new technology;
 - new lines, products, or activities;
 - corporate restructuring;
 - foreign operations; and
 - accounting pronouncements.

Control Activities. Control activities are the various policies and procedures that help ensure that necessary actions are taken to address risks to achieving the entity's objectives. These policies and procedures include:

- performance reviews (reviews of actual performance against expected performance),
- information processing (controls that check accuracy, completeness, and authorization of transactions),
- physical controls (activities that assure the physical security of assets and records), and
- segregation of duties (separate authorization, recordkeeping, and custody).

Information and Communication. Information and communication includes the accounting system, consisting of the methods and records established to record, process, summarize, and report entity transactions and to maintain accountability of the related assets and liabilities. To be effective, the information and communication system must accomplish the following goals for transactions:

- identify and record all valid transactions,
- describe transactions on a timely basis,
- measure the value of transactions properly,
- record transactions in the proper time period,
- properly present and disclose transactions, and
- communicate responsibilities to employees.

Monitoring. Monitoring assesses the quality of internal control performance over time. Monitoring activities may be ongoing, separate evaluations, or a combination of the two.

Reportable Conditions

We performed a limited review of internal controls pertaining to the Principle Statements and Related Footnotes of DLA WCF for the year ended September 30, 1998. Our review of limited controls concentrated on previously disclosed weaknesses. Because our review of internal controls was limited, it did not disclose all matters in the internal controls over financial reporting that we might otherwise consider being reportable conditions.

Definition. Reportable conditions are matters coming to our attention relating to significant deficiencies in the design or operation of internal controls that in our judgment, should be communicated to management. These conditions could adversely affect the agency's internal control processes, which are designed to provide reasonable assurance concerning the reliability of financial reporting; the compliance with applicable laws and regulations; and the reliability of performance reporting. A material weakness in internal controls is a reportable condition in which the design or operation of internal controls does not reduce to a relatively low-level the risk that errors, fraud, or noncompliance will occur in amounts that are material to the financial statements, and not be detected timely by employees performing their normal functions. We noted certain matters involving the internal control structure that we consider material weaknesses

Followup on Prior Audit. We followed up on reportable conditions and material weaknesses in Inspector General, DoD, Report No. 98-148, "Internal Controls and Compliance With Laws and Regulations for the FY 1997 Financial Statements of the Defense Logistics Agency Working Capital Fund," June 5, 1998. Our review showed that despite commendable actions taken by DLA personnel to correct internal control deficiencies, most of the deficiencies had not been corrected as of September 30, 1998. Material weaknesses continued to exist in the Inventory, Fund Balance With Treasury, and Property, Plant, and Equipment accounts. DLA personnel were working on solutions that should improve the reporting of financial operations in FY 1999.

Accounting Systems. Because of the immense size and complexity of the DLA WCF, DLA relies extensively on automated systems to carry out its programs; manage resources; and to process, maintain, and report essential accounting and performance data. The automated systems used by DLA were designed primarily to manage WCF programs, such as processing 20 million requisitions annually; performing distribution functions for approximately 6 million line items valued at over \$90 billion (standard price); processing 27 million receipt and issue transactions annually; and reutilizing, transferring, or donating \$3.9 billion in surplus equipment and other property. The DLA automated systems also capture critical financial management data and furnish it to DFAS for use in preparing the financial statements.

Internal controls in a highly automated environment depend on the controls established to ensure the accuracy and completeness of transactions, records, and reports, and the avoidance, detection, and correction of errors. To be effective, general and application controls must be in place and working that ensure that.

- all actions taken by the DLA organizations that represent a financial event are identified, assembled, and recorded;

- all essential accounting information for each financial event is captured at the time the transaction is initially entered into the automated system,
- only authorized transactions are recorded,
- transactions are described in sufficient detail to classify them properly in the financial statements and in the proper accounting period;
- adequate audit trails to support summary balances and facilitate audits are maintained; and
- the value of the transactions are measured so that its monetary value can be recorded in the financial statements at historic cost or other appropriate cost basis.

DLA and DFAS reported in their FY 1998 annual statements of assurance that critical automated systems, including the Standard Automated Material Management System, the Defense Integrated Subsistence Management System, and the Defense Fuel Automated Management System substantially did not comply with the requirements outlined in the Federal Financial Management Improvement Act. Specifically, the critical automated systems did not comply with Federal financial management system requirements, applicable Federal accounting standards, and the U.S. Government Standard General Ledger at the transaction level. In addition, other critical systems, such as the Distribution Standard System, that maintains perpetual inventory records for approximately \$90 billion of inventory stored at the DLA distribution depots, were not evaluated for compliance with these requirements.

Our review of management disclosures pertaining to their critical systems and limited audit tests confirmed the DFAS and DLA conclusions that their systems do not comply with Federal system and accounting requirements. In addition, the automated systems were often inadequately documented, kept poor audit trails, and did not have the capability to provide timely access to the information contained in them. Accordingly, we could not rely on the critical systems to produce reliable financial data.

Overall Process to Prepare Financial Statements. DLA and DFAS have not established the processes and controls necessary to prepare timely and reliable

financial statements that facilitate an audit. An effective process to compile an auditable set of financial statements must include well-established procedures to.

- get early agreement on and document the methodology that will be used to prepare the financial statements early in the reporting cycle;
- prepare interim financial statements throughout the year and work out problems before year-end,
- collect complete accurate transaction summaries and post to the trial balance timely and consistent with Standard General Ledger posting requirements and Department of the Treasury posting guidance;

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- maintain the integrity of accounts throughout the year and establish adequate audit trails;
 - identify needed year-end adjusting entries, make all necessary adjustments, and maintain supporting documentation for each adjustment,
 - provide the auditors with a complete set of financial statements within a reasonable time after the end of the fiscal year; and
 - fully document and have personnel available to explain the source of all account balances and footnotes reported in the financial statements

These procedures were either not in place or were not operating effectively during FY 1998. Also, new financial statements were introduced in FY 1998, causing delays in DoD preparing implementing guidance

Inventory Record Accuracy. Maintaining accurate inventory records and effectively measuring the accuracy of those records continued to be a problem for DLA. In FY 1997, DLA used three different statistical sampling plans to measure record accuracy. However, none of the plans were designed to measure dollar value accuracy. Despite increased efforts during FY 1998 to improve its sampling techniques, DLA did not implement a sound statistical sampling plan to measure the dollar accuracy of its distribution depot inventory records. This issue is discussed in detail in IG, DoD, Report No. 99-080, "Status of the Defense Logistics Agency Plan to Measure Inventory Record Accuracy at the Distribution Depots Using Statistical Sampling," February 10, 1999.

During FY 1998, the General Accounting Office, in conjunction with the IG, DoD, and the Military Department audit organizations, performed control testing at the DLA distribution depots. The depots kept the accountable records for most of the DLA WCF inventories. The control testing covered physical count procedures, inventory record adjustments, and research methods used to investigate the causes of record imbalances. The General Accounting Office's preliminary conclusions showed control weaknesses in all areas reviewed

Inventory Valuation. The methodology used to estimate the historic cost of ending inventories and cost of goods sold during the year was not adequate. Statement of Federal Financial Accounting Standard No. 3 requires that inventories be valued at historic cost, but allows DoD organizations to initially value inventories in the accounting records at their latest acquisition cost. If latest acquisition cost accounting is used, Federal accounting policy requires that the ending inventories and cost of goods sold during the year be adjusted to approximate historic cost. This is accomplished by establishing allowance accounts to capture unrealized gains and losses from the price changes that occur throughout the year and using the allowance accounts to revalue ending inventories and cost of goods sold at least annually.

In an attempt to comply with Statement of Federal Financial Accounting Standard No. 3, the Under Secretary of Defense (Comptroller) developed a methodology to convert inventories at latest acquisition cost to estimated historic cost. The methodology was established in DoD Regulation 7000.14-R, Volume 11B, "The DoD Financial Management Regulation - Reimbursable Operations, Policy and Procedures for the Defense Business Operations Fund," December 1994. The

Under Secretary of Defense (Comptroller) subsequently developed spreadsheet models that expanded upon the methodology in DoD Regulation 7000.14-R. DLA was required to use the DoD methodology to estimate the historic cost of its ending inventory and cost of goods sold.

The DoD methodology did not comply with Federal accounting standards regarding the treatment of inventory gains and losses, did not contain adequate guidance to properly account for established inventory transaction codes, and was not adequately documented. In addition, the methodology was dependent on unreliable information produced by the DLA automated systems and the ability of the DFAS to translate the DLA inventory accounts into the six inventory accounts that are in the U.S. Government Standard General Ledger.

Property, Plant, and Equipment. While DLA made improvements in the reporting of property, plant, and equipment on the financial statements, they may not have reported all existing or newly purchased assets. In addition, DLA did not have centralized control to inventory and reconcile its property, plant, and equipment records to on hand assets. As a result, we could not verify that the \$2.2 billion acquisition value of property, plant, and equipment assets or the \$1.45 billion of accumulated depreciation expense reported on the FY 1998 financial statements were complete and accurate.

Cash Reconciliations. The DFAS Columbus Center, Columbus, Ohio, did not reconcile cumulative DLA cash accounts (collections and disbursements) to the amounts reported to the Department of Treasury. Specifically, the DFAS Indianapolis Center, Indianapolis, Indiana, could not provide the DFAS Columbus Center with the value and number of DLA collections and disbursements that were reported to the Department of Treasury as undistributed by the DFAS Indianapolis Center. As a result, the DFAS Columbus Center could not make the required reconciliation and made over \$1 billion in unsupported adjustments to FY 1998 accounts receivable and accounts payable. In addition, DLA FY 1998 year-end obligated balance of \$4.6 billion and Fund Balance with Treasury of \$572.8 million were not verifiable.

Review of Compliance With Laws and Regulations

Reportable Conditions

The Deputy Under Secretary of Defense (Comptroller), the Director, DLA, and the Director, DFAS, are responsible for ensuring compliance with laws and regulations applicable to the DLA WCF. As part of obtaining reasonable assurance about whether DLA financial statements are free of material misstatement, we performed limited tests of compliance with certain provisions of laws and regulations that could have a direct and material effect on the determination of financial statement amounts. Because our review was limited, it did not identify all material instances of noncompliance with laws and regulations that affect the financial statements. Our review identified instances of potential noncompliance. The laws and regulations that we reviewed are listed in Appendix B.

Material instances of noncompliance with laws and regulations are failures to follow requirements, laws, or regulations that would cause an auditor to conclude that the aggregation of the misstatements resulting from those failures is either material to the financial statements, or that the sensitivity of the matter would cause others to perceive it as significant.

Title 31, United States Code, Section 501, Chief Financial Officers Act of 1990. The Chief Financial Officer Act of 1990, as amended by the Government Management Reform Act of 1994, requires DoD to prepare audited financial statements and submit them to OMB no later than March 1, 1999. OMB Bulletin No. 98-08, "Audit Requirements for Federal Financial Statements," requires, for the first time, that DLA WCF prepare audited financial statements for FY 1998. Due to the lack of an overall process to compile the data needed to prepare accurate and timely financial statements, we did not receive the financial statements in time to conduct necessary audit procedures.

Federal Financial Management Improvement Act of 1996. Under the Federal Financial Management Improvement Act of 1996 we are required to report whether the agency's financial management systems substantially comply with the Federal financial management systems requirements, Federal accounting standards, and the United States Government Standard General Ledger at the transaction level. To meet this requirement, we reviewed and evaluated DLA and DFAS self-disclosures regarding the reliability of the critical automated systems used to prepare the DLA WCF financial statements. We also evaluated their plans to correct known system deficiencies and the impact that the system deficiencies have on the overall DLA internal control structure and DLA ability to receive favorable audit opinions.

DLA and DFAS are collectively responsible for the financial management systems that support the DLA WCF. DLA is responsible for the nonfinancial data systems that supply approximately 80 percent of the data reported on the financial statements. These data are then transferred into the accounting and finance systems that are the responsibility of DFAS. DFAS used data from the

accounting systems and from those nonfinancial data systems to compile the FY 1998 DLA WCF Financial Statements. DLA and DFAS financial management and feeder systems did not substantially comply with the three requirements discussed in the preceding paragraph.

Federal Financial Management System Requirements. Federal financial management system requirements were established in OMB Circular A-127, "Financial Management Systems," July 23, 1993. This Circular requires financial management systems to provide complete, reliable, consistent, timely, and useful information. To achieve this goal, DoD must establish and maintain a single, integrated financial management system. In addition, the Joint Financial Management Improvement Program has published a series of "Federal Financial Management System Requirements" that establish standard requirements for Federal agency's integrated financial management systems. For FY 1998, the financial management systems that support DLA did not substantially comply with Federal financial management system requirements as follows:

- there were almost \$7 billion in inventory adjustments made during FY 1998,
- the fuels accounting system does not account for fuel at the point of sale,
- the accounts receivable subsidiary ledger does not match summary general ledger balance,
- no automated accounting module exists for the subsistence commodity, and
- there was a lack of adequate audit trails in most systems.

Federal Accounting Standards. Federal agencies reporting under the Government Management Reform Act of 1994 are to follow the Statements of Federal Financial Accounting Standards agreed to by the Director, OMB, the Comptroller General, and the Secretary of the Treasury. Currently, there are nine Statements of Federal Financial Accounting Standards and two Statements of Federal Financial Accounting Concepts. Our audit identified instances of noncompliance with the following standards:

- Statement of Federal Financial Accounting Standard No. 3, Accounting for Inventory and Related Property,
- Statement of Federal Financial Accounting Standard No. 4, Managerial Cost Accounting Concepts and Standards for the Federal Government, and
- Statement of Federal Financial Accounting Standard No. 6, Accounting for Property, Plant, and Equipment.

U.S. Government Standard General Ledger at the Transaction Level. OMB requires Federal agencies to implement the U.S. Government Standard General Ledger in their financial systems. The U.S. Government Standard General Ledger must be implemented at the transaction level. Federal agencies are permitted to

supplement their application of the U.S. Government Standard General Ledger to meet agency-specific information requirements. However, agency standard general ledgers must maintain consistency with the U.S. Government Standard General Ledger. For FY 1998, DLA finance and accounting systems did not use a standard, transaction-driven general ledgers.

DLA and DFAS have acknowledged that their financial management systems have significant procedural and systemic deficiencies, and have included a discussion of those deficiencies in their Annual Statements of Assurance. In addition, in September 1998, DoD published the first DoD Biennial Financial Management Improvement Plan (the Biennial Plan) that identifies many impediments to achieving auditable financial statements, including financial management system deficiencies. The Biennial Plan is intended to be a strategic financial improvement plan that addresses financial management systems. The Biennial Plan does not identify specific remedial actions for financial management system deficiencies and time frames to implement such actions.

Title 31, United States Code, Section 501, Chief Financial Officers Act of 1990. The CFO Act of 1990, as amended by the Government Management Reform Act of 1994, requires DoD to prepare audited financial statements and submit them to OMB no later than March 1, 1999. DoD fulfilled the CFO Act requirement for a CFO Five-Year Plan with its Biennial Plan. We did not receive the financial statements in time to conduct our audit procedures and meet the OMB deadline.

Title 31, United States Code, Section 65, Federal Managers' Financial Integrity Act of 1982. The Federal Managers' Financial Integrity Act of 1982 requires DoD to evaluate its systems of internal accounting and administrative controls to determine whether such systems can comply with the Act, and to prepare an Annual Statement of Assurance for the President and the Congress stating whether DoD systems of internal accounting and administrative control are in compliance with Act. DoD fulfilled part of the Federal Managers' Financial Integrity Act requirement by including the discussion of financial management systems deficiencies, traditionally published as Section 4 of the Annual Statement of Assurance, in its Biennial Plan. However, DLA did not disclose in its FY 1998 assurance statement the extent to which noncompliant systems and other significant control weaknesses prevented the agency from preparing reliable financial statements

Title 31, United States Code, Section 1101, Government Performance and Results Act of 1993. The Government Performance and Results Act of 1993 was enacted primarily to improve the confidence of the American people in the capability of the Federal Government by systematically holding Federal agencies accountable for achieving program results. The Government Performance and Results Act requires each Federal agency to submit to the Director of OMB and to

the Congress a strategic plan for program activities. Basically, the strategic plan should include:

- a comprehensive mission statement covering the major functions and operations of the agency;

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- general goals and objectives, including outcome-related goals and objectives, for the major functions and operations of the agency, and
 - a description of how the goals and objectives are to be achieved, including a description of the operational processes, skills, and technology, and the human, capital, information, and other resources required to meet those goals and objectives.

The Government Performance and Results Act also requires each Federal agency to prepare an annual performance plan covering each program activity set forth in the budget of the agency. The performance plan should:

- establish performance goals in an objective, quantifiable, and measurable form,
- briefly describe the resources necessary to meet the goals,
- establish performance indicators to be used in measuring or assessing the outcomes of program activity; and
- provide a basis for comparing actual program results with the established performance goals.

The DoD Form and Content requires that the DLA WCF include a discussion of its Government Performance and Results Act performance measures, consistent with the DoD Government Performance and Results Act Performance Plan as published in the Annual Defense Report, in the Overview section of the financial statements. We did not review the performance measures.

Appendix A. Audit Process

Scope

Statements Reviewed. We performed a limited review on the DLA WCF Financial Statements for FY 1998, which reported assets of \$12.7 billion and liabilities of \$1.8 billion. We determined whether amounts reported from major accounts were verifiable; reviewed management disclosures made in the financial statements and annual statements of assurance, and we evaluated DLA financial systems for compliance with Federal accounting requirements. We also followed up on prior audit reports on the DLA WCF. We reviewed version 2 of the financial statements, which were provided to us on January 19, 1999.

Scope Limitations. We determined that it was not feasible to perform a comprehensive financial statement audit in accordance with Government Auditing Standards because DLA and DFAS were not able to correct previously reported material deficiencies; the inability of critical automated systems to produce reliable data, and a lack of an overall process to compile the data needed to prepare accurate and timely financial statements. We performed limited tests of internal controls and compliance with laws and regulations applicable to the DLA WCF. These limited tests included:

- reviewing management disclosures made in the financial statements and annual statements of assurance;
- evaluating DLA financial systems for compliance with Federal accounting requirements;
- performing tests of internal controls related to accounting systems; the overall process of compiling data for the financial statements; inventory record accuracy; inventory valuation, property, plant, and equipment; cash collections and disbursements; and program costs;
- performing tests of compliance with laws and regulations such as the Chief Financial Officer Act, the Federal Financial Management Improvement Act, and Statements of Federal Financial Accounting Standards

The limited tests of internal controls and compliance with laws and regulations were not designed to disclose all material weaknesses in internal controls or material noncompliances with laws and regulations that might exist.

We did not obtain an understanding of the design of internal controls related to performance measures presented in financial statements.

Accounting Principles. Accounting principles and standards for the Federal Government are continually being refined and amended. The Federal Accounting Standards Advisory Board was established to recommend Federal Accounting Standards to three officials for approval. Those three officials are the Director,

OMB; the Secretary of Treasury; and the Comptroller General of the United States. The Director, OMB, and the Comptroller General issue standards agreed on by the three officials. To date, nine accounting standards and two accounting concepts have been published in final form. Those standards and concepts constitute generally accepted accounting principles for the Federal Government. OMB Bulletin No. 97-01 incorporates these standards and concepts and should be used by Federal agencies to prepare financial statements.

Agencies were required to follow the hierarchy of accounting principles outlined in OMB Bulletin No. 97-01, as amended on November 20, 1998. The hierarchy includes:

- standards agreed to and published by the Director, OMB; the Secretary of the Treasury; and the Comptroller General of the United States;
- interpretations related to the Statements of Federal Financial Accounting Standards issued by OMB;
- requirements for the form and content of financial statements in OMB Bulletin No. 97-01; and
- accounting standards contained in agency accounting policy and accounting principles published by other authoritative sources.

Review of Internal Controls. DoD Directive 5010.38, "Management Control Program," August 26, 1996, requires DoD organizations to implement a comprehensive system of management controls that provides reasonable assurance that programs are operating as intended and to evaluate the adequacy of controls. Because of the scope limitations discussed earlier, we revised our audit approach to focus on specific internal controls. We evaluated management's self-disclosures and performed limited tests of internal controls. We identified weaknesses in internal controls related to accounting systems, the overall process of compiling the financial statements, inventory record accuracy and valuation; property, plant, and equipment; cash reconciliation; and program costs. Our consideration of the internal controls would not necessarily disclose all reportable conditions that are also considered material weaknesses.

Review of Compliance With Laws and Regulations. Compliance with laws and regulations is the responsibility of DLA management. We performed a limited review of the compliance with laws and regulations related to the financial statements. We identified potential instances of noncompliance with laws and regulations such as the Chief Financial Officer Act, the Federal Financial Management Improvement Act, and Statements of Federal Financial Accounting Standards. A final determination as to whether DLA or DFAS did not comply with one or more specific provisions of law requires a legal interpretation. The instances of potential noncompliance that we identified materially affected the DLA WCF financial statements. Our review of laws and regulations was not intended to and would not disclose all instances of noncompliance with laws and regulations that might exist.

DoD-wide Corporate Level Government Performance and Results Act Goals. In response to the Government Performance Results Act, the DoD has established 6 DoD-wide corporate level performance objectives and 14 goals for

meeting these objectives. This report pertains to achievement of the following objective and goal

Objective: Fundamentally reengineer the DoD and achieve a 21st century infrastructure. **Goal:** Reduce costs while maintaining required military capabilities across all DoD mission areas. (DoD-6)

DoD Functional Area Reform Goals. Most major DoD functional areas have also established performance improvement reform objectives and goals. This report pertains to achievement of the following functional area objectives and goals.

Financial Management Area. Objective: Strengthen internal controls. **Goal:** Improve compliance with the Federal Managers Financial Integrity Act. (FM-5.3)

General Accounting Office High Risk Area. The General Accounting Office has identified several high-risk areas in the DoD. This report provides coverage of the Defense Financial Management high-risk area.

Methodology

Auditing Standards. We conducted this financial-statement audit in accordance with generally accepted Government auditing standards issued by the Comptroller General of the United States, as implemented by the IG, DoD, and OMB Bulletin No. 98-08. Those standards require that we plan and perform the audit to obtain reasonable assurance that the financial statements are free of material misstatements. We also relied on our professional judgement in assessing the materiality of matters affecting the fair presentation of the financial statements, related internal controls, and compliance with laws and regulations.

Computer-Processed Data. We did not rely on computer-processed data in performing our assessment of internal controls and compliance with laws and regulations. However, not relying on the data did not affect our opinion.

Audit Period. The audit was conducted from October 1998 through February 1999.

Representation Letters. We received a management representation letter from DLA dated February 15, 1999. DLA addressed deficiencies in its critical accounting systems in its management representation letter. We also received a legal representation letter from DLA dated February 15, 1999. The legal representation letter identified a claim of \$263.9 million for breach of contract. See Exhibit 1 for the management and legal representation letters.

Contacts During the Audit. We visited or contacted individuals and organizations within DoD. Further details are available on request.

Summary of Prior Coverage

The General Accounting Office and the IG, DoD, have conducted multiple reviews related to financial statement issues. Last year we issued a disclaimer on the FY 1997 DLA Working Capital Fund Financial Statements. General Accounting Office reports can be accessed over the Internet at <http://www.gao.gov>. IG, DoD, reports can be accessed over the Internet at <http://www.dodig.osd.mil>.

Appendix B. Laws and Regulations Reviewed

Public Law 104-208, "Federal Financial Management Improvement Act of 1996,"
October 1, 1996

Public Law 103-356, "Government Management Reform Act of 1994,"
October 13, 1994 (Title IV of this Act may be cited as the "Federal Financial
Management Act of 1994")

Public Law 101-576, "Chief Financial Officers Act of 1990," November 15, 1990

Public Law 97-255, "Federal Managers' Financial Integrity Act of 1982,"
September 8, 1982

OMB Bulletin No. 98-08, "Audit Requirements for Federal Financial
Statements," August 24, 1998, as amended January 25, 1999

OMB Bulletin No. 97-01, "Form and Content of Agency Financial Statements,"
October 16, 1996 as amended on November 29, 1998

OMB Circular No. A-127, "Financial Management Systems," as revised July 23,
1993

Statement of Federal Financial Accounting Standards No. 3, "Accounting for
Inventory and Related Property," October 27, 1993

Statement of Federal Financial Accounting Standards No. 4, "Managerial Cost
Accounting Concepts and Standards for the Federal Government," July 31, 1995

Statement of Federal Financial Accounting Standards No. 6, "Accounting for
Property, Plant, and Equipment," November 30, 1995

DoD Regulation 7000.14-R, "DoD Financial Management Regulation," volume 6,
"Reporting Policy and Procedures," February 1996

DoD Regulation 7000.14-R, "DoD Financial Management Regulation," volume
11B, "Reimbursable Operations, Policy and Procedures – Defense Business
Operations Fund," December 1994

DoD Directive 5010.38, "Management Control Program," August 26, 1996

Appendix C. Report Distribution

Office of the Secretary of Defense

Under Secretary of Defense (Comptroller) and Chief Financial Officer
Deputy Chief Financial Officer
Director, Accounting Policy
Deputy Comptroller (Program/Budget)
Assistant Secretary of Defense (Public Affairs)
Director, Defense Logistics Studies Information Exchange

Department of the Army

Auditor General, Department of the Army

Department of the Navy

Assistant Secretary of the Navy (Financial Management and Comptroller)
Auditor General, Department of the Navy

Department of the Air Force

Assistant Secretary of the Air Force (Financial Management and Comptroller)
Auditor General, Department of the Air Force

Other Defense Organizations

Director, Defense Contract Audit Agency
Director, Defense Finance and Accounting Service
Director, Defense Logistics Agency
Director, National Security Agency
Inspector General, National Security Agency
Inspector General, Defense Intelligence Agency

Non-Defense Federal Organizations and Individuals

Office of Management and Budget
General Accounting Office
National Security and International Affairs Division
Technical Information Center

Congressional Committees and Subcommittees, Chairman and Ranking Minority Member

Senate Committee on Appropriations
Senate Subcommittee on Defense, Committee on Appropriations
Senate Committee on Armed Services
Senate Committee on Governmental Affairs
House Committee on Appropriations
House Subcommittee on Defense, Committee on Appropriations
House Committee on Armed Services
House Committee on Government Reform
House Subcommittee on Government Management, Information, and Technology,
Committee on Government Reform
House Subcommittee on National Security, Veterans Affairs, and International Affairs,
Committee on Government Reform

Appendix D. Defense Logistics Agency Comments



IN REPLY
REFER TO

FOX

DEFENSE LOGISTICS AGENCY
HEADQUARTERS
8725 JOHN J. KINGMAN ROAD, SUITE 2533
FT. BELVOIR, VIRGINIA 22060-6221



FEB 16 1999

MEMORANDUM FOR ASSISTANT INSPECTOR GENERAL FOR AUDITING

SUBJECT: Audit Report on Internal Controls and Compliance with Laws and Regulations for the Defense Logistics Agency Working Capital Fund Financial Statements for FY 1998 (Project No. 9FJ-2005.03)

The purpose of this letter is to satisfy the requirements of Office of Management and Budget Bulletin No. 98-08 with regard to subject report. This bulletin indicates that reporting entities "shall provide comments on the auditor's findings and recommendations included in the audit report, including corrective actions taken or planned and comments on the status of corrective actions taken on prior findings."

The Defense Logistics Agency (DLA) is committed to improving its financial reporting in compliance with the Chief Financial Officer Act of 1990 and in support of the Administration's goal to obtain a favorable audit opinion on government-wide financial statements. The Assistant Inspector General for Auditing has acknowledged the progress DLA has made towards that goal in the audit report and has been instrumental in helping the Agency to make that progress. The audit report is a fair representation of the status of the Agency's financial reporting and of the problems the Agency faces in producing audited financial statements.

DLA agrees that central to obtaining an audit opinion on its financial statements is an effective and efficient financial reporting process. DLA, in conjunction with the Defense Finance and Accounting Service - Columbus Center, established a plan of action and milestones to improve FY 1998 financial reporting. Implementing that plan and achieving the milestones were less than successful due to several factors. DLA will work with DFAS and the DoJ to improve the FY 1999 reporting plan using FY 1998 lessons learned. The plan will address the deficiencies in the FY 1998 process identified in the audit report.

DLA has developed plans of action and specific milestones to address reporting deficiencies in property, plant and equipment and inventory valuation. The plans include implementing a statistical sampling plan to measure inventory dollar accuracy; verifying that DLA capital assets are properly recorded and depreciated; evaluating the Distribution Standard System (DSS) for compliance with financial reporting guidelines; and establishing additional internal controls to improve future financial reporting. In FY 1999, DLA will also participate with the Department in identifying additional strategies to improve financial reporting and will implement and report on the DoD implementation strategies that have been issued to date.

Federal Recycling Program



Printed on Recycled Paper

With respect to the audit report's findings on cash reconciliation and undistributed collections and disbursements, DLA will work with DFAS to obtain the proper emphasis on correcting this deficiency. DLA will also work with DFAS to correct accounting systems' deficiencies that hinder accurate and timely financial reporting.

Lastly, with regard to DLA's FY 1998 financial statement and subject audit report findings, DLA improved the overview section to discuss its mission, strategic plan, goals and objectives, and performance measures. We believe this discussion and the performance reported is consistent with that required by the Government Performance and Results Act.

With respect to previous audit report findings, subject audit report concludes that not all previously identified deficiencies have been corrected. While the conclusion is accurate, DLA has corrected many of the deficiencies cited in previous audit reports of its financial statements. The following addresses previously cited major deficiencies and their statuses.

- The deficiencies cited in DoDIG Audit Report No. 97-097, Capitalization of Software Developed for the Distribution Standard System (DSS), were resolved during FY 1998. These assets are properly reported in DLA's FY 1998 financial statements and internal controls have been established to ensure proper reporting of centrally funded assets.
- The deficiencies cited in DoDIG Audit Report No. 97-148, Defense Logistics Agency Actions to Improve Property, Plant and Equipment Financial Reporting, have also been addressed. This report covered the Distribution business area's real property assets.
- The deficiencies cited in DoDIG Audit Report No. 98-178, Military Department Materiel Returns to the Defense Logistics Agency Distribution Depots, have been corrected. DLA established procedures to identify unauthorized materiel returns; issued additional guidance on returns; and established a policy for recovering costs incurred for unauthorized returns.
- DLA corrected the deficiencies, to the extent that Departmental policy permitted, identified in DoDIG Audit Report No. 98-195, Valuation and Presentation of Inactive Inventory on the FY 97 Defense Logistics Agency Working Capital Fund Financial Statements.
- In the past DLA failed to establish allowance accounts to capture unrealized gains and losses and using them to revalue ending inventories. DLA's FY 1998 financial reporting of inventory includes an allowance for holding gains and losses in accordance with DoD policy.

- DLA has established a plan of action and milestones to correct the deficiencies cited in DoDIG Report No. 99-080, Status of the Defense Logistics Agency Plan to Measure Inventory Record Accuracy at the Distribution Depots using Statistical Sampling. During FY 99, DLA will develop and implement a sampling plan designed to validate inventory dollar values and will obtain input from personnel familiar with CFO reporting to that plan. Personnel familiar with advanced statistical sampling techniques will develop the plan.

In summary, DLA has improved its financial reporting and will continue to work with the Defense Finance and Accounting Service and the DoDIG to take those actions required to obtain a favorable audit opinion on its future financial statements.



B. A. BLACKMAN
Chief, Financial Policy and
Managerial Accounting
Office of Comptroller

Exhibit 1. Management Representation Letter



DEFENSE LOGISTICS AGENCY
HEADQUARTERS
8725 JOHN J. KINGMAN ROAD, SUITE 2533
FT. BELVOIR, VIRGINIA 22060-6221

FEB 15 1999

IN REPLY
REFER TO FOX

MEMORANDUM FOR ASSISTANT INSPECTOR GENERAL FOR AUDITING

SUBJECT: Management Assurance Concerning FY98 DLA Working Capital
Fund Financial Statements

This memorandum is in connection with your audit of the FY98 DLA Working Capital Fund Financial Statements (Project No. 9FJ-2005). The financial statements include the Principal Statements (which consist of the Balance Sheet, the Statement of Net Cost, the Statement of Changes in Net Position, the Statement of Budgetary Resources, the Statement of Financing, and the Notes to the Principal Statements) and the Required Supplementary Stewardship Information as of September 30, 1998. This memorandum addresses the audit's purpose of: (1) expressing an opinion as to whether the financial statements and required supplementary stewardship information are presented fairly, in all material respects, in conformity with Federal accounting standards, and (2) reporting whether the Agency's financial management systems substantially comply with Federal financial management systems requirements, applicable Federal accounting standards, and the U.S. Government Standard General Ledger at the transaction level as of September 30, 1998.

We confirm, to the best of our knowledge and belief, the following representations made to you during your audit are accurate as of the date of your auditor's report, and pertain to the period covered by the principal financial statements.

a. We are responsible for the fair presentation of the FY98 DLA Working Capital Fund Financial Statements in conformity with Federal accounting standards.

b. The FY98 DLA Working Capital Fund Financial Statements are fairly presented in conformity with Federal accounting standards except as disclosed in the footnotes.

c. We have made available to you all:

- 1) Financial records and related data.
- 2) Communications from OMB concerning noncompliance with or deficiencies in financial reporting practices that are not a matter of public record.

d. There are no material transactions that have not been properly recorded in the accounting records underlying the financial statements or disclosed in the notes to the financial statements.

e. The DLA has satisfactory title to all owned assets; such assets have no liens or encumbrances, nor have any assets been pledged.

f. We have no plans or intentions that may materially affect the carrying value or classification of assets and liabilities.

g. Guarantees under which the agency is contingently liable have been properly reported or disclosed.

h. Related party transactions and related accounts receivable or payable, including assessments, loans, and guarantees, have been properly recorded and disclosed.

i. All intragovernmental transactions and activities have been appropriately recorded, reported, and disclosed.

j. There are no:

1) possible violations of laws or regulations whose effects should be considered for disclosure in the financial statements or as a basis for recording a loss contingency.

2) material liabilities or gain or loss contingencies that are required to be accrued or disclosed that have not been accrued or disclosed.

3) unasserted claims or assessments that are probable of assertion and that must be disclosed that have not been disclosed.

k. We have complied with all aspects of contractual agreements that would have a material effect on the financial statements in the event of noncompliance.

l. No material events or transactions have occurred subsequent to September 30, 1998, that have not been properly recorded in the financial statements and required supplementary information or disclosed in the notes thereto.

m. There has been no material fraud (intentional misstatements or omissions of amounts or disclosures in financial statements and misappropriation of assets that could have a

material effect on the financial statements) or any fraud involving management or employees who have significant roles in internal control.

n. We are responsible for establishing and maintaining internal controls.

o. Pursuant to the Federal Managers Financial Integrity Act, we have assessed the effectiveness of DLA's internal control in achieving the following objectives:

1) Reliability of financial reporting - transactions are properly recorded, processed, and summarized to permit the preparation of the financial statements and Required Supplementary Information in accordance with Federal accounting standards and the safeguarding of assets against loss from unauthorized acquisition, use, or disposition.

2) Compliance with applicable laws and regulations - transactions are executed in accordance with (a) laws governing the use of budgetary authority and other laws and regulations that could have a direct and material effect on the financial statements and (b) any other laws, regulations, and Government-wide policies identified by the Office of Management and Budget (OMB) in Appendix C of OMB Bulletin 98-08.

3) Reliability of performance reporting - transactions and other data that support reported performance measure are properly recorded, processed, and summarized to permit the preparation of performance information in accordance with criteria stated by management.

p. Those controls in place on September 30, 1998, provided reasonable assurance that the foregoing objectives were met except for the effects of the material weaknesses discussed in subparagraph s.

q. We are responsible for implementing and maintaining financial management systems that comply substantially with Federal financial management systems requirements contained in OMB Circular A-127, "Financial Management Systems," applicable Federal accounting standards, and the United States Government Standard General Ledger (SGL) at the transaction level.

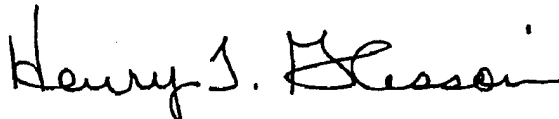
r. We have assessed the financial management systems to determine whether they comply substantially with these Federal financial management systems requirements. Our assessments were based on criteria established under OMB Circular A-127 and guidance issued by OMB and included in Appendix D of OMB Bulletin 98-08.

s. The financial management systems do not comply substantially with Federal financial management systems requirements, applicable Federal accounting standards, and the SGL at the transaction level as of September 30, 1998.

t. We are responsible for DLA's compliance with applicable laws and regulations.

u. We have identified and disclosed to you all laws and regulations that have a direct and material effect on the determination of financial statement amounts.

v. We have disclosed to you all known instances of noncompliance with laws and regulations.

A handwritten signature in dark ink, appearing to read "Henry T. Glisson". The signature is fluid and cursive, with a large initial "H" and a stylized "G".

HENRY T. GLISSON
Lieutenant General, USA
Director

Exhibit 2. Legal Representation Letter



IN REPLY
REFER TO

DEFENSE LOGISTICS AGENCY
HEADQUARTERS
8725 JOHN J. KINGMAN ROAD, SUITE 2533
FT. BELVOIR, VIRGINIA 22060-6221

GC

February 15, 1999

MEMORANDUM FOR ASSISTANT INSPECTOR GENERAL FOR AUDITING
OFFICE OF THE INSPECTOR GENERAL
DEPARTMENT OF DEFENSE

SUBJECT: Defense Logistics Agency Working Capital Fund for FY 1998

As General Counsel of the Defense Logistics Agency (DLA), I am responding to the annual requirement for a legal representation in connection with your examination of the DLA Working Capital Fund (WCF). This FY 1998 representation covers significant actual or potential litigation, claims, and assessments, including matters handled by outside legal counsel on behalf of DLA. For purposes of this representation, "significant" is defined as claims equal to or greater than \$117 million that pertain to the DLA WCF.

The General Counsel, DLA, has general supervision over the Agency's legal affairs, including those involving the WCF. In that capacity, I have reviewed actual and potential claims involving the WCF.

Subject to the last paragraph of this memorandum, I advise you that in FY 1998, neither I, nor any of the lawyers over whom I exercise general supervision, have given substantive attention to, or represented, the WCF in connection with material loss contingencies coming within the scope of clause (a) of Paragraph 5 of the Statement of Policy referred to in the last paragraph of this letter, except as indicated in the attachment to this memorandum.

The information set forth covers matters that existed in FY 1998 and up to February 1, 1999.

I confirm that in the course of performing legal services for DLA, I have advised the Comptroller, DLA, of all unasserted possible claims or assessments that, in my professional judgment, should be disclosed or considered for potential disclosure on DLA financial statements, in accordance with Statement of Financial Accounting Standard (SFFAS) Number 5, "Accounting for Contingencies" (December, 1995).

This response is limited by, and in accordance with, the ABA Statement of Policy Regarding Lawyers' Responses to Auditors' Requests for Information (December 1975). Without limiting the generality of the foregoing, the limitations set forth in Paragraphs 2 and 7 of the SFFAS on the scope and use of this response are specifically incorporated



herein by reference, and any description herein of any "loss contingencies" is qualified by Paragraph 5 of the SFFAS and accompanying Commentary, which is an integral part of the SFFAS. Consistent with the last sentence of Paragraph 6 of the American Bar Association Statement of Policy, this will confirm as correct the Agency's understanding that: (1) whenever in the course of performing legal services for the Agency with respect to a matter recognized to involve an unasserted potential claim or assessment that may call for financial statement disclosure; (2) I have formed a professional conclusion that the Agency must disclose, or consider disclosing said claim; (3) I, or one of the lawyers over whom I exercise general legal supervision, as a matter of professional responsibility, will so advise the Agency and will consult with the Agency's managers concerning the question of such disclosure and the applicable requirement of SFFAS Number 5.



BRUCE W. BAIRD
General Counsel

Attachment

cc:

Comptroller, DLA
DDAI (Ms. Williams)

ATTACHMENT: Case 1

The EROS appeals before the Armed Services Board of Contract Appeals (the Board), ASBCA Nos. 48355 and 48367, represent a claim of approximately \$263.9 million for breach of contract. The current status is summarized below.

- 1) This is a claim for alleged breach of contract and improper use of proprietary data, based on the termination for convenience of Government contract No. SP4410-94-R-1001 in July of 1994. The contract, awarded June 8, 1994, involved the scrapping and consignment resale of parts and metal from B-52 aircraft at the Davis-Monthan AFB, Tucson, Arizona
- 2) The appeals were denied by the Board in their entirety in a decision dated December 31, 1998. Eros has 120 days from receipt of the decision to file an appeal. Not knowing when the decision was received by the appellant, DLA does not know the precise date the appeal period will expire. Absent an appeal, this matter will be closed by the end of May, 1999.
- 3) No outside counsel represent the Agency. In-house counsel at DRMS represent the contracting officer.

**Exhibit 3. Financial Statements and Auditor
Opinion**



COMPTROLLER

OFFICE OF THE UNDER SECRETARY OF DEFENSE
1100 DEFENSE PENTAGON
WASHINGTON, DC 20301-1100


JAN 19 1999

MEMORANDUM FOR DIRECTOR FOR FINANCE AND ACCOUNTING, ASSISTANT
INSPECTOR GENERAL FOR AUDITING, OFFICE OF THE
INSPECTOR GENERAL, DEPARTMENT OF DEFENSE

SUBJECT: Defense Logistics Agency Working Capital Fund Version 2, FY 1998 Financial
Statements

Attached are the version 2 FY 1998 financial statements for the Defense Logistics
Agency Working Capital Fund.

My staff contact for this action is Mr. Thomas Tresslar. He may be reached by
e-mail: tresslat@osd.pentagon.mil or by telephone at (703) 693-6502.


De W. Ritchie, Jr.
Director for Accounting Policy

Attachment



IN REPLY
REFER TO

**DEFENSE LOGISTICS AGENCY
HEADQUARTERS
8725 JOHN J. KINGMAN ROAD, SUITE 2533
FT. BELVOIR, VIRGINIA 22060-6221**



JAN 14 1999


FOX

**MEMORANDUM FOR UNDER SECRETARY OF DEFENSE (COMPTROLLER)
ATTN: Accounting Policy (Mr. Tom Tresslar)**

**SUBJECT: Defense Logistics Agency FY98 Working Capital Fund Financial
Statements**

Attached is Version 2 of DLA's unaudited FY98 Working Capital Fund financial statements. Please be aware that we significantly altered the footnotes from those that were provided by the Defense Finance and Accounting Service (DFAS) with Version 2. As a result, data in some footnotes cannot be reconciled to the statement entries. In these cases, the footnotes are correct and the entries, incorrect. These changes have been agreed to by DFAS and will be included in Version 3. Provided DFAS makes appropriate changes and provides us Version 3 on schedule, we expect to be in a position a position to meet the February 2nd submission deadline for the final statements.

My point of contact on this action is Mr. Buz Sawyer, DLA-FOXS, who may be reached at (703) 767-7204.


B. A. BLACKMAN
Chief, Financial Policy and
Managerial Accounting Group
Office of Comptroller

Attachment



Overview of the Principal Financial Statements

Defense Logistics Agency – Defense Working Capital Fund

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Introduction to the Defense Logistics Agency

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Introduction

The Defense Logistics Agency is the logistics combat support agency for the Department of Defense. The DLA mission is to provide acquisition and focused logistics support to America's armed forces in peace and war—around the clock, around the world. DLA provides centralized management of consumable supply items, supports surplus disposal programs, and provides contract administration services to the Military Services, as well as federal, state, and local governments, and foreign military organizations. Supported by a comprehensive strategic plan, DLA is continually reengineering and improving business practices to provide agile, integrated combat logistics solutions and life cycle support to the warfighter.

OUR VISION...

To be America's logistics combat support agency...
the warfighter's choice for integrated life cycle solutions
through teamwork and partnership.

OUR ETHOS...

We are warrior focused professionals, an integral part of the joint warfighting team. We know that victory by America's Armed Forces and the lives of service members depend on us. They can count on us to be there, every time, wherever they are, providing required logistical support...around the world, around the clock. We make a difference. We are Team DLA. We are proud!

Organization

DLA accomplishes its mission through two major subordinate commands: the Defense Logistics Support Command (DLSC) and the Defense Contract Management Command (DCMC). Staff support is provided by the Defense Automated Printing and Support Center and the Comptroller, General Counsel, Corporate Administration, and Chief Information offices. A secondary mission of DLA is the Department of Defense printing program, which is accomplished by the Defense Automated Printing Service.

INSERT DLA ORGANIZATIONAL CHART

During FY 1998, DLA employed just over 43,000 personnel and executed a total budget program of \$14.8 billion. The Agency is funded through Appropriations and the Defense Working Capital Fund (DWCF). DCMC is addressed here for the purposes of providing an overall view of the mission, programs, and size of DLA. However, DCMC is funded through appropriations and therefore, is reported in the DoD General Fund financial statement.

The highlighted organizations above represent the five DLA business areas that are included in these statements and reported in the DWCF. They are: Supply Management, Distribution, Reutilization and Marketing, Information Services, and Automated Printing. The DWCF was created to establish a customer-provider relationship between the military operating forces and support organizations that would result in improved delivery of support services and reduced cost of operations. The financial structure of the DWCF allows for identification of the full costs of support and measures performance to foster efficiency and productivity improvements. The DWCF also enables the customer to make economical choices by providing timely and accurate financial information to the decision-maker.

Agency Goals

In FY 1998, DLA implemented a comprehensive strategic plan that supports the Department of Defense's (DoD) Joint Vision 2010 (JV -2010), and emphasizes the tenet of "focused logistics," one of the four critical operational concepts of JV-2010. The tenet of focused logistics emphasizes improved logistics process performance, new technologies and business practices, improved information technology in support of Service requirements, and identifies and integrates highly successful logistics initiatives. These concepts, which are set forth in the Quadrennial Defense Review and the DoD Logistics Strategic Plan, are echoed in the DLA Strategic Plan.

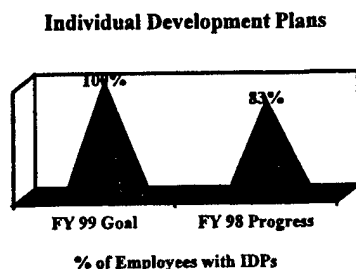
The DLA Strategic Plan outlines our roadmap to the future and establishes metrics to measure our progress. Each of the goals and supporting objectives are implemented throughout the DLA business areas to ensure that, by sharing a common vision, we can continue our successes.

Strategic Goals
<ul style="list-style-type: none">• Consistently provide responsive, best value supplies and services to our customers.• Serve as a catalyst for the Revolution in Business Affairs and acquisition reform.• Ensure our workforce is enabled to deliver and sustain world class performance.• Rapidly exploit technology to provide agile, responsive, interoperable solutions.• Aggressively pursue partnerships with industry and our suppliers.

Agency Objectives

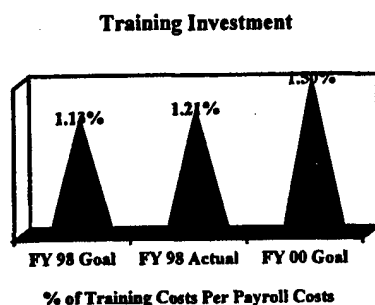
Each strategic goal provides a series of supporting objectives, with targeted success dates ranging from FY 1999 to FY 2005. The DLA business areas have strategies to support Agency goals and objectives. Progress is reported quarterly. Many of these strategies are tied directly to unique, business-area specific focused logistics efforts and will be addressed later in further detail. However, objectives involving all business areas are coordinated, tracked and reported by staff level organizations. Objectives related to workforce development and information technology are well underway.

- **Individual Development Plans:** To achieve our goal of ensuring that the workforce is enabled to deliver and sustain world class performance, we have established an objective to develop individual training plans for all employees by the end of FY 1999. The Agency is identifying core competencies, researching private sector and government programs on competency based training plans to develop the best approach to maximizing resources.



- **Training Investment:** Another objective is to achieve a training investment level of at least 1.5% of gross payroll cost, linked to documented individual development plans, by FY 2000. This goal reflects private industry benchmarks. DLA

surpassed the interim goal for FY 1998 and is on track to meet the FY 2000 objective. Enhancements in configuration and tracking systems are being implemented to ensure accurate tracking and monitoring of training costs.



- Implementing our Information Technology Strategic Plan: Implementing the Information Technology (IT) Strategic Plan is one of the primary objectives of the strategic goal to rapidly exploit technology to provide agile, responsive, and interoperable solutions. The Chief Information Office is leading an IT Management Team-chartered, cross-functional working group that is currently refining the implementation objectives. The IT Plan will be fully implemented by FY 2001, with substantial completion by FY 1999.

The objectives include developing outcome measures and targets, developing objective implementation plans, establishing data collection procedures, and institutionalizing performance measuring and reporting. When implemented, the IT Strategic Plan will: implement a client/server standards based architecture; establish an IT capital planning and investment control process; ensure our workforce has the current IT skills through continuous IT education and training; and institutionalize a corporate systems life-cycle management process.

Year 2000 Issues

DLA began Year 2000 (Y2K) remediation of its systems in 1996. As of December 31, 1998, 26 of 33 mission critical systems have been implemented, which constitutes Y2K certification and deployment. The remaining 7 mission critical systems will be implemented between January and May 1999. DLA non-mission critical systems are scheduled for implementation by March 1999.

DLA estimates a total cost of \$43 million for remediation of systems, devices, and facility items, and additional costs of \$38 million for testing and supplier capability initiatives.

An issue of risk to DLA is the ability of our suppliers to continue to provide products required by our customers. DLA is working closely with vendors and suppliers in assessing the risk and testing systems to help ensure that our system interfaces operate in a Y2K compliant infrastructure.

DLA is currently testing Business Continuity and Contingency Plans that can be used to sustain our mission in the event of a failure to any system supporting our critical logistics and procurement functions.

Business Area Missions

The DLA business areas included in the DWCF and reported herein are:

- Defense Logistics Support Command includes three business areas:
 - The **Supply Management** business area provides customer support through management of logistics processes. This includes inventory management of consumable items for both peacetime and combat support, and technical support to ensure product quality and proper pricing of materiel.
 - The **Distribution Depot** business area provides distribution and storage of wholesale and retail materiel in support of customers worldwide. This includes receipt, storage, issue, packing, preservation and transportation for over 5 million categories of consumable items used by the warfighter.
 - The **Reutilization and Marketing Service** business area supports reuse of excess and surplus property within the government and other authorized agencies. This business area is also responsible for disposal of remaining property and hazardous waste items through sales and contractual vehicles.
- The **Information Services** business area provides software development and maintenance, and technology and infrastructure support through a single Central Design Activity. In addition, the business area includes the Defense Automatic Addressing Systems Center, which provides transmission and routing of logistics transactions throughout DoD.
- The **Automated Printing Services** business area provides printing, duplicating and document automation for DoD. The current focus is on the transition from hardcopy to electronic-based documents management.

Defense Logistic Support Command

A significant portion of the DLA mission is achieved through the Defense Logistics Support Command (DLSC), which is one of DLA's major subordinate commands. The newly formed DLSC fully integrates the functions of logistics information, materiel management, distribution, and disposal. The DLSC mission is to provide focused logistics support to America's Armed Forces. The Command manages DoD fuel, food, medical supplies, and clothing commodities, in addition to 90% of the DoD consumable spare parts. The DLSC mission implements the Department of Defense Joint Vision 2010 by providing logistics support to the warfighter through processes designed to implement *focused logistics*, which is outlined in the Department of Defense Logistics Strategic Plan. The Department's key logistics goals are to:

- Provide timely and responsive support to warfighters and other customers.
- Achieve maximum logistics productivity.

Some of the key objectives of the DoD Logistics Strategic Plan, which are supported by DLA through DLSC, include: Customer Satisfaction; Logistics Response Time; Reengineered Logistics Business Processes; Significantly Reduced Logistics Costs to the Customer; Modernize Selected Logistics Information; Competitive Sourcing; Inventory Reduction; Infrastructure Reduction/Capacity Utilization; Virtual Inventory Control Point; and Skilled Logistics Workforce. The DLSC Long-Range Business Plan goals, which are consistent with the DLA Strategic Plan goals, re-iterate these DoD principles. The DLSC Long-Range Business Plan contains 24 near-term objectives with quantifiable performance metrics targeted for implementation between FY 2000 and FY 2005. The current near-term performance measures will be addressed under each DLSC business area.

Three business areas within DLSC work together to provide integrated and focused logistics support: Supply Management, Distribution, and Reutilization and Marketing.

DLA Performance – Supply Management

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Overview

The Supply Management business area provides materiel and services to support peacetime and combat operations, combat preparedness, and humanitarian aid. This includes integrated materiel management of 4 million spare and repair parts supporting over 1400 weapon systems. Supply Management also provides management of troop support items including subsistence, clothing and textiles, medical supplies, and the purchase and sale of over 100 million barrels of fuel annually. Together these commodities generated FY 1998 annual revenues of \$13.0 billion, nearly 98% of which represented sales to the Military Services. Approximately 9,800 personnel support the Supply Management business area.

The Supply Management business area operates through four Defense Supply Centers located in; Columbus, OH; Richmond, VA; and two in Philadelphia, PA; and the Defense Energy Support Center in Ft. Belvoir, VA.

Mission

The mission of Supply Management is to provide customer support through management of logistics processes, to ensure that logistics support is provided to the Military Services worldwide at the right time, to the right place, and consistently at the best value in peacetime, emergency, and wartime scenarios. Our mission is dynamic as we continue to shift our approach in response to evolving changes in national priorities, requirements of the Military Services, technology, and the commercial marketplace. The primary logistics functions include:

- Inventory management for both peacetime and combat support
- Transportation management (shared with the Distribution business area) for quick response in both normal and emergency situations
- Technical management, which guarantees product quality and proper pricing of materiel
- Procurement management, ensuring DoD gets the best value in procuring supplies managed by DLA
- Obtain, manage and integrate, and distribute logistics data and information

Goals

The long-term goals of the Supply Management business area are consistent with the goals contained in the DLA Strategic Plan. These goals will be achieved through a series of supporting strategies:

- Information technology will be leveraged to provide efficient integrated logistics support
- Business practices will be continually improved or reengineered to increase efficiency
- Teamwork and partnerships will be used to develop business relationships advantageous to the customer
- Our workforce will continue to receive the training needed to provide integrated solutions for world class support
- Effective and efficient supplier relationships will be leveraged to improve our buying power.

FY 1998 Accomplishments

- Defense Supply Center Philadelphia initiated the Virtual Wartime Visibility (VWV), which allows the Center to develop and access commercial market information to maintain visibility over the War Reserve items needed to support the Military Services wartime feeding plan. This plan will enhance the Services' readiness and sustainability in emergency and wartime scenarios.

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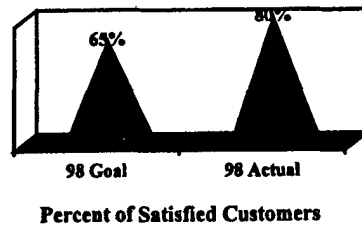
- Defense Supply Center Philadelphia expanded the Vendor Managed Inventory (VMI) Program, which provides the Military Services with guaranteed access to over 600 pharmaceuticals and ensures on-time materiel availability to deploying units. This program also provides wartime sustainment materiel, which ensures adequate troop supplies during contingency mobilization or deployment, until the commercial industrial base can adequately support expanded requirements.
- Defense Industrial Supply Center initiated the Prime Vendor Program for facility maintenance which enables procurement of supplies related to Maintenance, Repair, and Operations (MRO) of facilities directly from integrated supply chain contractors. The goal is to leverage our buying power through large contracts at discounted commercial prices, and provide rapid response. The program allows DLA to meet the customers need quickly and at lower prices. It reduces the requirement for inventory stocks and results in reduced overall maintenance supply support infrastructure costs.
- Defense Energy Support Center developed the Service Station Initiative. This program will result in significant savings in maintenance, construction, and environmental restoration by using contractors to provide infrastructure and services for fuel support. With limited military construction funds and the increased emphasis on outsourcing, this program aims to reduce infrastructure costs associated with maintaining military facilities and ensuring compliance with environmental laws. The pilot program began in FY 1998 at Fort Bragg, NC.
- Vice President Al Gore's National Partnership for Reinventing Government (NPR) recognized two successful reinvention efforts in Supply Management business practices with Hammer Awards in FY 1998. These are:
 - The Defense Ozone Depleting Substances Reserve. Located at the Defense Supply Center and Defense Distribution Depot Richmond, the Reserve provides DoD with the capability to centrally receive, reclaim and issue Class I ozone-depleting substances. This effort conserves reuse of ozone depleting substances, protects the environment, and reduces procedural requirements to customers on their returns of ozone depleting substances.
 - Bid Evaluation Model. This automated system is used to determine the overall lowest cost for more than \$3 billion worth of annual fuel contracts. It was radically reengineered by the Defense Energy Support Center to incorporate advances in information technology that allow it to determine fuel distribution patterns more efficiently and economically; and process calculations and reports at much greater speed. The result is more informed decision making for cost effective fuel contracts.
 - The Defense Industrial Supply Center was among 11 finalists for the Presidential Quality Award

Performance Measures

The following performance measures are in direct support of the DLA Strategic Plan goals and the Department's logistics concepts. These program and financial performance measures are those that best support the business activity goals and near-term objectives from our customers' perspective.

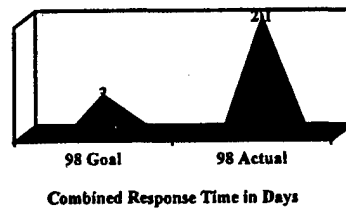
Customer Satisfaction Index: This measure directly supports the DLA Strategic Plan objective of achieving a 90% customer satisfaction rate by FY 2000. The results reflect the percentage of customers who responded that they were either "very satisfied" or "satisfied" with the Defense Logistics Support Command products and services.

Increase Customer Satisfaction



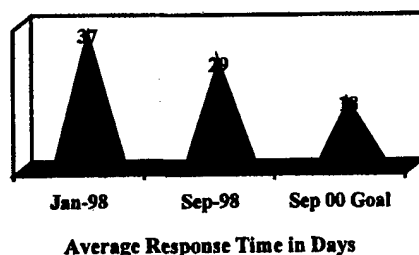
Logistics Response Time (LRT) for Immediate Issues: The LRT performance measures support the DLA Strategic Plan goal of consistently providing responsive, best value supplies and services to our customers. Because integrated logistics support for consumable items includes support from both the inventory control points and the distribution depots, this metric reflects the number of days required to provide the integrated support of the Supply Management and Distribution business areas. DLSC has established a response time goal of 2 days for material issued immediately from inventory stocks, and actually experienced an average response time of 2.1 days. The goal represents the DLA time anticipated at the Inventory Control Point and Depot to process the requisition, package the items, and provide delivery to on-base or nearby sites. It is important to understand that the total response time experienced by the customer—from the time the user places an order until the time that the user receives the item—is 18 days for immediate issue items. The additional 16 days represents the average amount of time that the user organization takes to process and deliver the requisition to DLA and the time consumed for delivery of the item to the actual end-user after DLA ships it.

Reduce DLSC Combined Logistics Response Time



Logistics Response Time (LRT) for Total Pipeline (Immediate and Delayed Issues): Some orders, where requisitioned material is not immediately available from stock and must be backordered, are called delayed issues. Delayed issues represent a significantly longer response time than immediate issues. DoD has targeted a 50% reduction in the response times for the combined immediate issues and delayed issues (total pipeline LRT) measured against the FY 1997 baseline of 36 days. This equates to a FY 2000 target response time of 18 days for the total pipeline, which includes immediate and delayed issues. Based on the actual FY 1998 experience, DLSC is on target to meet the DoD FY 2000 goal.

Reduce Total Customer Logistics Response Time

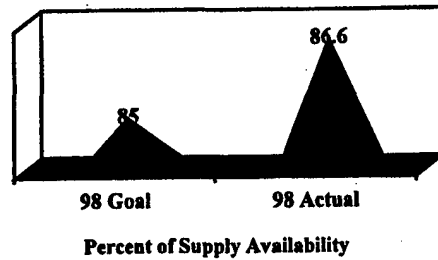


Response Times for Integrated Logistics/Commercial Practices: Consistent with providing responsive, best value supplies and services to our customers, DLSC satisfies many requisitions from commercial stocks rather than from inventory. As such, DLSC has established contractual agreements with commercial sources to supply items directly to the Military customers. Often, these arrangements allow the requiring activity to order material directly from the commercial supplier, within a negotiated time for delivery. This performance measure is somewhat different than the other LRT measures, in that the goal is to meet or exceed customer expectations, for which there is no specific numeric metric. If the provider meets the negotiated response time, and can deliver more rapidly than deliveries from DLA inventories, both the military customer and DLA experience lower overall costs, infrastructure investment and inventory costs. The following times represent the typical negotiated direct delivery contract requirements, or the actual experienced delivery times:

Energy (Fuel):	100% on-demand availability
Subsistence (Food) and Medical Items:	2 days
Clothing and Other Textiles:	21 days
Hardware and Repair Parts:	23 days

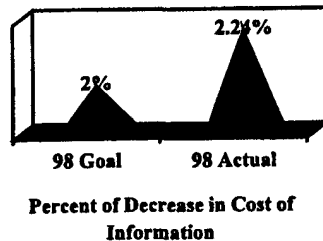
Weapon Systems Supply Availability: This measure directly supports the DLA Strategic Plan goal to consistently provide responsive, best value supplies and services to our customers. In FY 1998, DLA exceeded the composite goal of 85% set by DLA for weapon system supply availability. However, the availability did not meet 85% for each Military Service. Low stocks of critical aviation supplies, for which DLA assumed management only recently, and the DLA focus on investing in fast-moving, lower-priced items, resulted in the Navy and Air Force supply availability averaging slightly below the 85% goal. DLA is focusing on replenishing aviation supply levels. Anticipated increases in FY 1999 funding authority will be used to improve aviation system supply performance for our Navy and Air Force customers. Overall, supply availability increased over FY 1997, resulting in a decrease of backordered items.

Increase Weapon System Supply Availability



Reduce Cost of Logistics Information: This measure directly supports the DLA Strategic Plan objective of reducing total costs to our customers. This metric reflects the reduction in the price that the Defense Logistics Information Service charges for logistics services and information products, which ultimately results in a lower price for consumable items. Examples of information products are supply chain-related training, extracts, and database and catalog updates.

Reduce Cost of Logistics Information



Financial Performance Measures: In addition to program performance measures, DLA measures the effectiveness of program budgeting and execution with unit cost performance measures. The following table depicts the Supply Management unit cost results for the Energy (fuel) commodity and the composite non-energy commodities:

<u>Financial Performance Measures</u>	<u>FY 1998 Goal</u>	<u>FY 1998 Actual</u>
Cost per Barrel of Fuel\$	\$ 25.8700	\$ 20.2700
Non-Energy Cost per Dollar of Sales	\$ 00.9600	\$ 00.9594

The Cost per Barrel of Fuel includes the acquisition cost of a barrel of fuel in addition to costs for fuel services, transportation, and overhead. The non-Energy cost represents the acquisition value of material in addition to overhead and other support costs.

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DLA Performance – Distribution Depots

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Overview

The Distribution business area is responsible for the receipt, storage, issue, packing, and preservation of consumable items, as well as delivery of materials from its warehouses to on-base or nearby customer sites such as ships, posts, and repair facilities. DLA also contracts with a variety of commercial sources to transport items from vendors or DLA's own warehouses direct to customers worldwide. The function includes distribution of items managed by DLA and items managed by the Military Services, which results in unique complexities associated with maintaining accountability for items owned by several components. In FY 1998, the Distribution business area executed 25.9 million transactions and managed nearly 266 million cubic feet of occupied storage space.

In FY 1998, the Distribution business area reduced overhead by consolidating regional control of the distribution depots in a single distribution activity called the Defense Distribution Center. The DDC manages 21 subordinate distribution depots throughout the Continental United States and Europe. In FY 1998, this business area generated revenues of nearly \$1.4 billion and includes 12,140 personnel.

Mission

The mission of the Distribution business area is to ensure that consumable items under its control are provided to the Military Services worldwide at the right time, to the right place, and consistently at the best value in peacetime, emergency, and wartime scenarios. The Distribution mission integral part of providing integrated logistical support to the warfighters.

Goals

The goals of the Distribution business area are consistent with the goals contained in the DLA Strategic Plan. These goals are achieved through a series of supporting strategies:

- Increase our reliability, response, and value to our customers by continually improving or reengineering our business practices
- Review our activities, and implement changes as necessary, to ensure efficiency, effectiveness, and best value costing for our customers
- Reduce under-utilized infrastructure by eliminating unnecessary storage capacity

FY 1998 Accomplishments

- World Wide Express (OCONUS Express Commercial Service): DLA, in partnership with the Air Mobility Command established a multi-theater commercial contract, which will serve as a means to provide reliable, cost-effective International Express Delivery of small packages while also providing door pickup and delivery, customs clearance and in-transit visibility.
- Defense Distribution System and FedEx Powership Plus Interface: DLA and Federal Express formed a partnership to build an interface to electronically transmit shipment information for domestic small package express shipments. The depot benefits from processing time savings and the ability to print one label containing both military shipping labels and FedEx information/barcodes.
- Overseas Destinations—Commercial Direct Delivery: This commercial express service ships directly from the Defense Depots to the overseas customer, and avoid delays at intermodal transportation nodes. With the agreement of TRANSCOM, DLA uses three commercial contractors to ship high-priority items directly to the overseas customer.

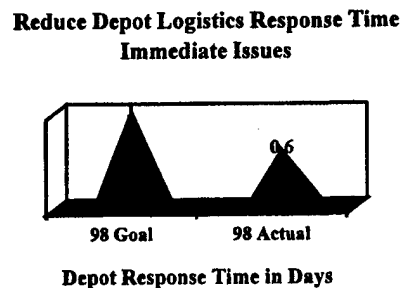
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- **Premium Service:** This service has Federal Express fly low volume but readiness-critical items from a central warehouse in Memphis, TN anywhere in the United States in 24-hours, and anywhere in the world in 48 hours, when expedited delivery is necessary. During 1998, we shipped 174,180 issues and received 11,233 return receipts using this service.
- Vice President Al Gore's National Partnership for Reinventing Government (NPR) recognized the success of the Distribution Standard System with a Hammer Award. DLA developed and implemented a single distribution system at all DoD distribution depots. Previously, the Agency and each of the Military Services operated supply depots using different systems, which made changes and improvements to depot operations difficult and expensive. Instead of developing a new system, DLA reviewed existing DoD systems and selected one which could be modified and enhanced to best meet DoD needs at the lowest cost. The Distribution Standard System brings many business process improvements, such as inventory accuracy and workload planning.

Performance Measures

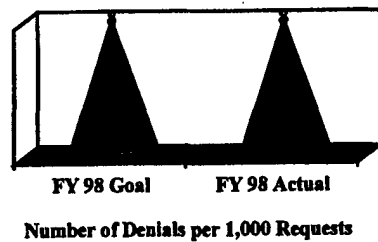
The following performance measures are in direct support of the DLA Strategic Plan goals. The program and financial performance measures that best support the business activity goals and near-term objectives are:

Depot Logistics Response Time: This measure directly supports the DLA Strategic Plan goal of consistently providing responsive, best value supplies and services to our customers. The Distribution Business area has established a goal of less than or equal to one day for both high-priority immediate issues and routine issues from stock. This measures the average number of days to process a customer order or requisition, from the time the order is received at the depot to the date the material is shipped.



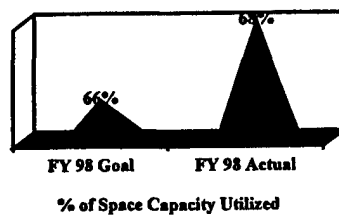
Denials: This measure also directly supports the DLA Strategic Plan goal of consistently providing responsive, best value supplies and services to our customers. This metric measures denial incidents per 1000 requests for issues. A denial incident occurs when an item on recorded on the inventory records is not on-hand or cannot be located and made available for issue to a customer.

Reduce Denial Incidents



Infrastructure Reduction: The Distribution business area, in an effort to reduce infrastructure costs, measures storage capacity and occupancy to identify improvements in space utilization rates and eliminate unnecessary space. The goal of increasing space utilization ties directly to the DLA Strategic Plan goal to serve as a catalyst in business affairs and acquisition reform, and the objective to reduce overall infrastructure. In FY 1998, the planned space utilization rate of 66% was exceeded by 2%.

Utilization Rates



Financial Performance Measures: In addition to program performance measures, DLA measures the effectiveness of program budgeting and execution with unit cost performance measures. The following table depicts the Distribution unit cost results for each of their receipt and issue categories:

<u>Financial Performance Measures</u>	<u>FY 1998 Goal</u>	<u>FY 1998 Actual</u>
Bin Receipts	\$ 21.84	\$ 21.87
Medium Bulk Receipt	36.15	34.94
Hazardous/Heavy Bulk Receipts	56.30	56.56
Bin Issues On Base	12.95	12.59
Bin Issues Off Base	16.63	17.71
Medium Bulk Issues On Base	27.86	26.19
Medium Bulk Issues Off Base	36.12	38.62
Haz/Heave Bulk Issues On Base	52.49	49.60
Haz/Heave Bulk Issues Off Base	101.56	109.07
Transshipments	4.61	5.23
Unit Cost – Total	24.94	25.78

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Unit Cost – Covered Storage

\$ 7.89

\$ 6.31

DLA Performance – Reutilization & Marketing Service

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Overview

The Defense Reutilization and Marketing Service (DRMS) coordinates the reuse of excess and surplus property for the Department of Defense and other authorized agencies. Items that are not reutilized within DoD are screened for possible transfer to other Federal agencies, or for donation to local governments. Surplus property that cannot be reutilized is offered for sale to the public on a competitive basis. DRMS also oversees the disposal of remaining property and hazardous waste items through sales and contractual vehicles.

Command and control of the DRMS mission is accomplished from the headquarters organization in Battle Creek, MI. The mission is accomplished through Defense Reutilization and Marketing Offices (DRMOs) located on military installations throughout the world. DRMOs receive, classify, segregate, demilitarize, account for and report excess materiel for screening, lot categorization, merchandising, and sale. The FY 1998 mission was performed with just under 3,300 personnel and generated revenues of \$590M. A significant portion of the FY 1998 revenues resulted from a \$351 million Service Level Billing effected to recoup prior year losses in DRMS.

Mission

The Defense Reutilization and Marketing Service manages the reutilization, transfer, donation and sale of military personal property, as well as disposal of hazardous waste items no longer needed for national defense. The goal is to maximize the financial return on the initial equipment investment, and protect both valuable natural resources and the environment.

Goals

The long-term goals of the Reutilization and Marketing business area are consistent with the goals contained in the DLA Strategic Plan. These goals are achieved through a series of supporting objectives and initiatives designed to improve and reengineer business practices to ensure efficiency, effectiveness, and best value costing.

FY 1998 Accomplishments

- Commercial Venture: In 1998, the Defense Reutilization and Marketing Service awarded its first commercial venture contract, which provides the contractor with exclusive rights to purchase property consisting of machine tools, bearings, service trade equipment, warehouse equipment, electronics, hardware, marine, railroad and construction equipment. The contractor purchases the property and can resell it using private sector sales processes. Upon resale, 80% of proceeds will be returned to DRMS and 20% to the contractor. This partnership with private industry is expected to increase sales revenue and reduce costs. The results of this first commercial venture will be analyzed to determine award of additional contracts for other types of commodities.
- Recycling Control Point (RCP): Under this initiative, disposal property is "received" into a Recycling Control Point account via an electronic transaction with the actual property remaining in place on the Defense Depot shelves. RCP automates the screening and sales process via the DRMS Internet World Wide Web Site and property moves from the depot only when directed by DRMS for shipment to ultimate customer. This decreases costs through reduced physical handling and movements, and improves accountability.
- Foreign Military Sales – The Defense Reutilization and Marketing Service created a foreign military sales (FMS) Web site that allows access to a searchable and sortable database. FMS customers can search the inventory by National Stock Number, item name, weapon system, and geographical location to obtain descriptive data. Photos are also available for some items. The program manager received one of ten Outstanding Defense Logistics Agency Employee of the Year awards for these efforts.

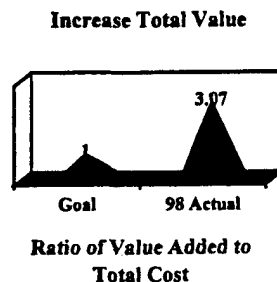
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Performance Measures

There are very few performance measures presented for DRMS for FY 1998. During FY 1998, DRMS began to develop additional program performance measures that are in direct support of the DLA Strategic Plan. Those additional performance measures will be in effect during FY 1999 and reported in the Statements accordingly.

Total Value: This measure directly supports the DLA Strategic Plan goal of consistently providing responsive, best value supplies and services to our customers. The Total Value ratio identifies the total value of the services provided by DRMS, as compared to the cost to provide the services. For example, the current ratio of 1:3.07 means that the Defense Reutilization and Marketing Service provides a benefit to DoD that is three times greater than costs.

In FY 1998, DRMS transferred, or donated over \$5 billion in items, based on latest acquisition value. This \$5 billion represents cost avoidance to DoD, Federal, and State customers, and is achieved at a cost of \$.013 on the dollar of acquisition value. For the fifth year in a row, DRMS has reduced customer costs in the hazardous waste disposal area, using innovative contracting techniques, improved automation and improved hazardous waste management and identification. In FY 1998, the average disposal cost declined from \$.27 per pound to \$.22 per pound. Additionally in FY 1998, a longstanding \$18 million backlog in customer reimbursements was eliminated and new procedures were developed and implemented to ensure that all reimbursements are made in a timely manner.



(NOTE: Total value is derived by adding: the projected revenue from scrap sales, usable sales, FMS sales, precious metals, a credit for full acquisition value of serviceable reutilization requests, a cost savings credit for dispositions minus reutilization calculated at 2.5% of acquisition value, plus a cost avoidance credit for HM reutilization, transferred, donated or sold in lieu of ultimate disposal.)

Financial Performance Measures: In addition to program performance measures, DLA measures the effectiveness of program budgeting and execution with unit cost performance measures. The following table depicts the Defense Reutilization and Marketing Service unit cost results for each of their support categories:

Financial Performance Measures	FY 1998 Goal	FY 1998 Actual
Cost/Dollar of Acquisition Value		
- Reutilization/Transfer/Donation	\$ 0.01496	\$ 0.01296
Cost/Dollar of Sales Proceeds	1.05510	1.01250
Cost/Pound - Ultimate Disposal	0.19500	0.18500
Cost/Line - Abandonment and Destruction	\$ 293.72000	\$ 241.53000

DLA Performance – Information Service

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Overview

The Information Services business area serves as a primary provider of integrated information management support. This support is provided by the Defense Automatic Addressing System Center (DAASC) located in Dayton, OH and Tracy, CA, and the DLA System Design Center (DSDC) headquartered in Columbus, OH and supported by eight geographically dispersed satellite sites. In FY 1998 the Information Services business area consisted of approximately 1,100 employees with revenue of \$104.8 million. Non-DLA customers accounted for 23% of the FY 1998 revenue.

Mission

The mission of the Information Services business area is to provide integrated information management support by delivering products and services of increasing quality and decreasing cost, on time and within budget. This support is provided through three major program areas: Software Development and Maintenance; Technology and Infrastructure Support, and; the Defense Automatic Addressing System Center and Laboratory Operations.

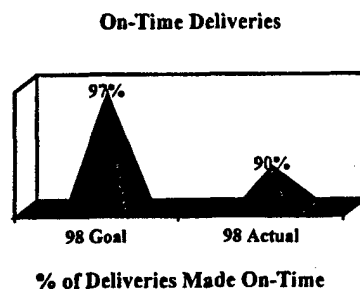
Goals

The success of the Information Services business area is largely determined by the satisfaction of its customers. DSDC's primary goal is to provide consistently responsive, best value supplies and services to its customers. Accomplishment of this goal is achieved through improved productivity, quality, and delivery. DSDC seeks to deliver 95% of products on time and within budget.

Another, extremely critical goal for the Information Services business area is to ensure that all DSDC-supported Information Systems are compliant for Year 2000. DSDC has developed a number of important objectives in this area to include: complete remediation of DSDC supported business systems, complete transition to the OS/390 operating environment and full integration testing of all Y2K supported software.

Performance Measures

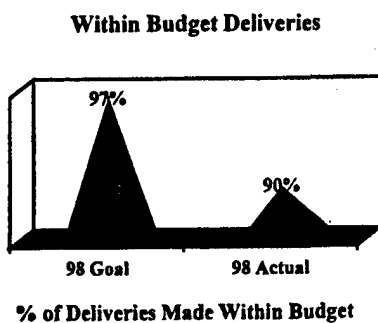
On-Time Delivery Rate: This measure relates directly to the DLA Strategic Plan goal of providing responsive, best value supplies and services to our customers. It also has a direct relationship to customer satisfaction. This measure reflects the percentage of time that projects are delivered to the customer within 5% of the originally scheduled or re-baselined estimated time for completion. It is used by management to determine DSDC's ability to forecast project efforts.



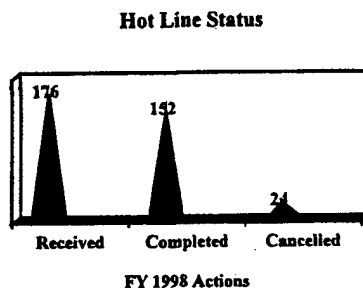
Within Budget Delivery Rate: This measure also relates to DLA Strategic Plan objective of meeting or beating our price commitments and reducing total costs. This measure reflects the percentage of time that projects are delivered to the

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customer within 5% of the originally estimated or re-baselined cost projections. It is use by management to measure the effectiveness of DSDC's ability to forecast project and task costs.



Hot Line Calls: This measure directly relates to DLA Strategic Plan objectives for customer satisfaction and product reliability. It identifies the quality of DSDC software products that are implemented as operational systems. The metric is the number of actual system defect calls received by the Hotline desk. The defects must be classified as application-based, and not operational in nature.



Financial Performance Measures: The following table depicts the FY 1998 unit cost goal and actual for the DLA Systems Design Center.

<u>Financial Performance Measure</u>	<u>FY 1998 Goal</u>	<u>FY 1998 Actual</u>
Unit Cost Rate	\$57.24	\$62.72

DLA Performance – Automated Printing Service

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Overview

The Defense Automated Printing Service (DAPS) is responsible for the Department of Defense (DoD) printing program and document automation encompassing value-added conversion, electronic storage and output and the distribution of hard copy and digital information. All DoD printing requirements, whether produced in-house or procured through the Government Printing Office (GPO), are forwarded to DAPS to ensure compliance with DoD Directives and the Federal Printing Program. The Congressional Joint Committee on Printing exercises oversight of all federal printing including the DAPS in-house printing capability.

DAPS manages a worldwide printing, duplicating, and document automation production and procurement network. The DAPS Corporate Support Team is located at Ft Belvoir, Virginia with 80 major field locations and 238 smaller document automation facilities located in 12 countries. Approximately 1,900 civilian personnel support the DAPS mission. DAPS had FY 1998 revenue of \$377.8 million. DAPS's primary customers are Army (21.8%), Navy (31.1%), Air Force (16.2%), Defense agencies (22.7%), and non-DoD customers (8.2 %).

Mission

The Defense Automated Printing Service provides automated printing services world-wide in support of America's Armed Forces, encompassing electronic conversion, retrieval, output, and distribution of digital and hardcopy information. DAPS provides quality products and services that are competitively priced and delivered on time to their customers.

DAPS is the recognized leader in document automation and is the customer-preferred provider of best value automated digital and hardcopy information products and services. DAPS is dedicated to the transition from paper to electronic-based document management, and is an integral part of the Department of Defense plan to transition into the age of electronic documents and business practices.

Goals

The long-term goals of the Automated Printing Service business area are consistent with the goals contained in the DLA Strategic Plan. These goals will be achieved through a series of supporting objectives. Some of the primary objectives planned for implementation by FY 2000 are:

- Design the organization with the minimum personnel and infrastructure to effectively execute its mission. This includes determining the DAPS Most Efficient Organization and developing a plan for reducing costs, as well as benchmarking our products and services against the best in private industry.
- Maintain a constant focus on our commitment as a customer driven organization. This includes meeting or exceeding customer delivery requirements and the customer satisfaction metric, as well as effectively inform all customers of DAPS products and services.
- Promote the full portfolio of document automation services to our customers. This includes marketing plans to promote digital services, the Department Product Line, and improving the technical expert image of DAPS.
- Build Team 2000 Skills. This objective includes meeting the DLA Strategic Plan goal of establishing Individual Development Plans for all DAPS employees by the end of FY 1999, and investing at least 1.5% of gross payroll costs in training.

Overview of the Principal Financial Statements

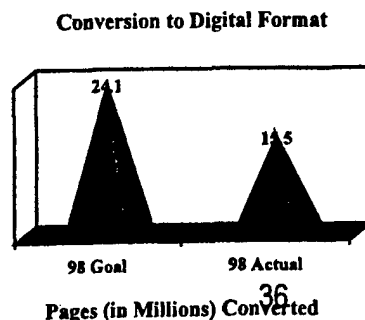
- Partner with government to improve synergistic relationships. This includes partnering with the Government Printing Office to outline roles and relationships, and ensure that DoD customers receive the best value.
- Develop and implement a "DAPS At The Desktop Strategy" to connect customers to DAPS sites. This includes implementing the DAPS Information Technology plan and Network Strategy.

FY 1998 Accomplishments

- Vice President Al Gore's National Partnership for Reinventing Government (NPR) recognized the DAPS effort for changing a labor-intensive process for recording Government Bills of Lading to an automated system with a Hammer Award. This effort resulted in increased accuracy and timeliness of obligation data: electronic storage and data retrieval where the invoices were paid, reduced late payment penalties, increased visibility of transportation payments, and reduced requirements for paper.
- Implementation of the Defense Working Capital Accounting System (DWAS) was completed. DWAS is the first commercial off-the-shelf DoD migratory accounting system and the first to fully implement the U.S. Government Standard General Ledger.
- DLA signed a DoD/GSA Partnering Agreement for DAPS to provide document automation services to GSA and other federal agencies. GSA's ten remaining duplicating centers were transferred to DAPS, which is estimated to result in \$4.3 million in annual savings to the federal government.
- Using an extended GSA contract with major equipment manufacturers, DAPS is now offering the Multi-Functional Device (MFD), which can simultaneously deliver at least two of the following functions: print, copy, scan, and fax. Successful partnering in the Cost-Per-Copy Program and the new Group Connection Program (MFDs) will result in savings between 5 to 35 percent to the customers.
- DAPS is continuing to accelerate the acceptance of the universal I.M.P.A.C. for intra-government sales, which has significantly increased accessibility of its products and services with the card. DAPS transactions number over 130 thousand, worth \$48 million, with savings estimated at \$70-92 per transaction.

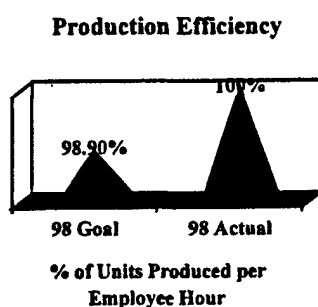
Performance Measures

Conversion to Digital Format: This goal is tied to the DLA Strategic Plan goal to serve as a catalyst for the revolution in business affairs and acquisition reform. DAPS measures the number of pages (in millions) converted to digital format. This measure focuses on accelerating the use of document automation technology. Conversion of pages may be accomplished in-house or by contract, and include hardcopy to digital, system output to digital, and from one form of digital to another. DAPS exceeded the goal in FY 1998, largely because initiatives emphasizing automation, including several Defense Reform Initiative Decisions, served as a catalyst for DAPS customers to seek out the DAPS expertise in digital conversion.

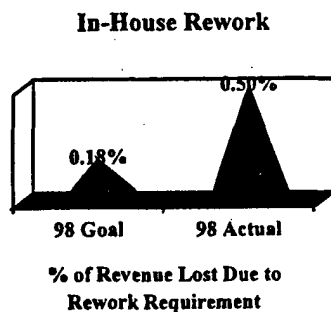


Customer Satisfaction: This metric ties to the DLA Strategic Plan goal of consistently providing responsive, best value supplies and services to our customers. DAPS uses a survey of a statistical sampling of customers to determine an overall customer satisfaction rating. Satisfied customers are measured by the percentage of customers ranking DAPS performance from acceptable through high quality. The survey was last conducted during FY 1996 and another survey is planned for FY 1999 with a goal of 90% overall customer satisfaction.

Production Efficiency Factor: This metric ties to the DLA Strategic Plan goal of consistently providing responsive, best value supplies and services to our customers. Production standards are established for each production process and are stated in terms of units produced per hour. The units are converted to standard hours earned. Employee time is captured by cost center as hours available. The employee hours available are divided into the hours earned to produce the production efficiency factor shown as a percentage. DAPS performed slightly under the FY 1998 goal, largely due to lower than expected sales.



In-House Re-work Percentage: This metric ties directly to the DLA Strategic Plan goal of consistently providing responsive, best value supplies and services to our customers. This metric helps determine the cost of re-work. It is calculated by dividing revenue loss from orders not accepted by the customer by the total in-house production revenue.



Financial Performance Measures: In addition to program performance measures, DLA measures the effectiveness of program budgeting and execution with unit cost performance measures. The following table depicts the Automated Printing Service unit cost results for each of their support categories:

<u>Financial Performance Measures</u>	<u>FY 1998 Goal</u>	<u>FY 1998 Actual</u>
Offset Press	\$0.0402	\$0.0363
Electronic Impression	\$0.0299	\$0.0324

Overview of the Principal Financial Statements

Reproduction (Running Feet)

\$0.3346

\$0.2880

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Management's Discussion and Analysis of the Financial Statements

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Introduction, Purpose and Limitations of Financial Statements

These financial statements have been prepared to report the financial position and results of operations for the entity, pursuant to the requirements of the Chief Financial Officers Act of 1990 and the Government Management Reform Act of 1994. 31 U.S.C. 3515(b).

These financial statements include all of the DLA Working Capital Fund activities and associated budget authority. These statements have been prepared from the books and records of the Defense Logistics Agency, in accordance with the formats prescribed by the Office of Management Budget (OMB) Bulletin 97-01, "Form and Content of Agency Financial Statements." These statements are reconciled to the budgetary reports which are prepared from the same books and records, but on a different basis of accounting, – the same basis as the President's budget, rather than in accordance with the Generally Accepted Accounting Principals (GAAP).

The statements should be read with the realization that they are for an Agency of the U.S. Government, a sovereign entity. Intra-governmental assets and liabilities are those with other Federal Agencies. For example, DLA's Fund Balance is held by the U.S. Treasury Department, another Federal agency. DLA has no authority to pay liabilities not covered by its budgetary limitations. Liquidation of such liabilities requires enactment of an appropriation. Because the U.S. Government is a sovereign entity, certain liabilities, other than that for contracts, can be abrogated by new legislation.

The FY 1998 financial statements were developed in conformance with the Federal hierarchy of accounting guidance. In that regard, DLA used published Statements of Federal Financial Accounting Standards, OMB Form and Content Guidance, and the Department of Defense Financial Management Regulation.

Discussion and Analysis of Fiscal Year Operations and Financial Condition

The DLA DWCF business areas ended FY 1998 with total adjusted program costs of \$15.1 billion, and earned revenues of \$15.2 billion, for a net cost of operations of \$108 million. The positive net operating result was due in large part to the lower than expected price of fuel in the Supply business area, and the effect of a Service Level Billing to recover prior year losses in DRMS. The non-energy segment of the Supply Management business area, as well as the Distribution, Information Services and Automated Printing Services business areas, experienced losses in FY 1998. These losses are budgeted for recovery in FY 1999 and FY 2000.

Some significant management initiatives were factored into the financial planning for FY 1998 and ultimately effected the financial results. The Consumable Item Transfer, which is the DoD directed transfer of management of consumable items from the Military Services to the Defense Logistics Agency, continued in FY 1998. During the year, DLA received over 23,000 items and capitalized over \$700 million in inventory at standard cost. The transfer resulted in an increase in cash balances for the Defense-wide Working Capital Fund cash account, as DLA sold the transferred material that was initially purchased by the Military Services. To adjust for this impact, DLA made non-expenditure cash transfers of \$569.1 million to the appropriate Military Services during FY 1998. The transfer of consumable items ends in FY 1999.

In FY 1998, 28 Defense Reutilization and Marketing Offices in the continental United States were closed in order to properly size the disposal infrastructure to match current workload volume and dispersion. DRMS negotiated mutually satisfactory arrangements with effected customers for providing disposal services after the closures. FY 1998 also marked completion of the second phase of a 25% reduction in DRMS headquarters overhead positions. A total of 101 positions were eliminated within the headquarters overhead structure through consolidation, realignment, and reengineering efforts.

The Agency continued the directed consolidation of distribution depots, resulting in reduced infrastructure costs. The streamlining of overhead operations at the Defense Distribution Center in FY 1998 resulted in a reduction of 355 full time

Other Accompanying Information

equivalent personnel. These reductions will save \$16 million in FY 1999 and are projected to save a total of \$34 million in operations costs by FY 2000.

In FY 1998, both the Distribution and Reutilization and Marketing Service business areas began the process of competitive sourcing three distribution depots and ten Defense Reutilization and Marketing Offices (DRMOs) respectively. This process compares the government's Most Efficient Organization cost of logistics processes against private sector bids to perform the same services. If the private contractor proposal is at least 10% lower than the government cost, the functions are contracted out. The initial competitions will take approximately two years to complete, and it is anticipated that 13 additional depots and 58 additional DRMOs will be competed by the end of FY 2000.

Cost visibility across the Department has been a concern for a number of years. To gain additional visibility of cost and pricing structures, the Department of Defense has increased the emphasis on the use of Activity Based Costing (ABC). ABC provides detailed cost visibility, which can assist management in making decisions regarding streamlining of operations, as well as eliminate activity fragmentation. Pilot programs have been successfully completed at Defense Supply Center Columbus, Defense Logistics Information Service, Defense Distribution Depot Susquehanna, and Defense Reutilization and Marketing Services. Plans are to expand Activity Based Costing to all DLSC support activities by the end of CY 1999.

As required by the Federal Managers' Financial Integrity Act (FMFIA) of 1982, DLA has conducted an evaluation of the management control systems. One of the objectives of the system of internal accounting is to provide reasonable assurance that the revenues and expenditures applicable to agency operations are properly recorded and accounted for to permit the preparation of accounts and reliable financial and statistical reports and to maintain accountability over the assets. The results of the review indicate that the DLA internal accounting and administrative control systems in effect during FY 1998 are operating effectively. Material weaknesses were identified and reported in DLA's FY 1998 Annual Statement of Assurance, and corrective action plans have been developed and are currently being implemented. This review encompassed the operating accounting systems, as defined by the General Accounting Office (GAO), and was performed by the Defense Finance and Accounting Service. DLA has seven operating accounting systems, with one of the seven systems considered substantially in compliance with the GAO accounting principles, standards, and related requirements. The remaining six accounting systems contain one or more major nonconformance which preclude certification that the system is in substantial compliance with GAO guidelines. Those material nonconformances are also reported in the DLA Annual Statement of assurance. In any case, where an identified material weakness or nonconformance impacts the accounts reported in these Statements, it is annotated in the footnotes and/or the Management Representation Letter.

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Principal Financial Statements

*Defense Logistics Agency – Defense Working Capital
Fund*

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Department of Defense
 Defense Logistics Agency – Defense Working Capital Fund
 Consolidated Balance Sheet
 As of September 30, 1998

ASSETS**Entity Assets**

Intragovernmental

Fund Balance With Treasury (Note 2)	\$ 572,810,381.81
Investments (Note 4)	0.00
Accounts Receivable, Net (Note 5)	1,125,548,977.97
Other Assets (Note 6)	0.00

Total Intragovernmental	<u>\$ 1,698,359,359.78</u>
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Investments (Note 4)	0.00
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Accounts Receivable, Net (Note 5)	94,372,786.16
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Loans Receivable and Related Foreclosed Property, Net (Note 7)	0.00
-------------------------------------------------------------------	------

Cash and Other Monetary Assets (Note 3)	0.00
-----------------------------------------	------

Inventory and Related Property, Net (Note 8)	9,756,123,357.18
----------------------------------------------	------------------

General Property, Plant and Equipment, Net (Note 9)	832,455,365.03
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Stewardship Assets (National Defense PP&E, Etc.)	See Stewardship Statement
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Other Assets (Note 6)	720,421,396.76
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Total Entity Assets	<u>\$ 13,101,732,264.91</u>
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Non-Entity Assets

Intragovernmental

Fund Balance With Treasury (Note 2)	0.00
Accounts Receivable, Net (Note 5)	0.00
Other Assets (Note 6)	0.00

Total Intragovernmental	<u>\$ 0.00</u>
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Accounts Receivable, Net (Note 5)	0.00
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Cash and Other Monetary Assets (Note 3)	0.00
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Other Assets (Note 6)	83,306,946.80
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Total Non-Entity Assets	<u>83,306,946.80</u>
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Total Assets	<u>\$ 13,185,039,211.71</u>
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Principal Financial Statements

Department of Defense
Defense Logistics Agency – Defense Working Capital Fund
Consolidated Balance Sheet (continued)
For the period ending September 30, 1998

LIABILITIES

Liabilities Covered by Budgetary Resources

Intragovernmental Liabilities

Accounts Payable	\$ 777,710,876.91
Environmental Cleanup (Note 11)	0.00
Debt (Note 10)	0.00
Other Liabilities (Note 11, 12 and 15)	98,234,529.68
Total Intragovernmental	<u>875,945,406.59</u>

Accounts Payable	904,572,102.21
Liabilities for Loan Guarantees	0.00
Military Retirement Benefits and Other	0.00
Employment Related Actuarial Liabilities (Note 13)	0.00
Environmental Cleanup (Note 11)	0.00
Other Liabilities (Notes 11, 12 and 15)	125,897,142.75
Total Liabilities Covered by Budgetary Resources	<u>1,906,414,651.55</u>

Liabilities not Covered by Budgetary Resources

Intragovernmental Liabilities

Accounts Payable	0.00
Debt (Note 10)	0.00
Environmental Cleanup (Note 11)	0.00
Other Liabilities (Notes 11, 12 and 15)	0.00
Total Intragovernmental	<u>0.00</u>

Accounts Payable	0.00
Debt (Note 10)	0.00
Military Retirement Benefits and Other	0.00
Employment Related Actuarial Liabilities (Note 13)	190,516,866.00
Environmental Cleanup (Note 11)	0.00
Other Liabilities (Note 11, 12 and 15)	209,487,000.00
Total Liabilities not Covered by Budgetary Resources	<u>400,003,866.00</u>
Total Liabilities	<u>2,306,418,517.55</u>

NET POSITION

Unexpended Appropriations (Note 14)	0.00
Cumulative Results of Operations	10,878,620,694.16
Total Net Position	<u>10,878,620,694.16</u>
Total Liabilities and Net Position	<u>\$ 13,185,039,211.71</u>

Program Costs	
Intragovernmental	\$ 3,637,327,985.74
With the Public	<u>11,749,163,181.02</u>
Total Program Cost	15,386,491,166.76
Less: Earned Revenues	<u>(15,494,495,360.85)</u>
Net Program Costs	<u>(108,004,194.09)</u>
Costs Not Assigned to Programs	0.00
Less: Earned Revenues Not Attributable to Programs	(0.00)
Deferred Maintenance (Note 17)	
Net Cost Of Operations	<u>\$ (108,004,194.09)</u>

VERSION 2

Principal Financial Statements

Department of Defense
Defense Logistics Agency – Defense Working Capital Fund
Consolidated Statement of Net Position
For the period ending September 30, 1998

Net Cost of Operations	\$ (108,004,194.09)
Financing Sources (Other than Exchange Revenues)	
Appropriations Used	0.00
Taxes (and Other Non-exchange Revenue)	0.00
Donations (Non-exchange Revenue)	0.00
Imputed Financing	191,226,000.00
Transfers-In	1,616,435,103.11
Transfers-Out	<u>(1,437,750,142.09)</u>
Net Results of Operations	477,915,155.11
Prior Period Adjustments (Note 18)	<u>314,966,859.61</u>
Net Change in Cumulative Results of Operations	792,882,014.72
Increase (Decrease) in Unexpended Appropriations	<u>15,332,405.45</u>
Change in Net Position	808,214,420.17
Net Position-Beginning of the Period	<u>10,070,406,273.99</u>
Net Position-End of Period	<u>\$ 10,878,620,694.16</u>

Additional information included in Note 18.

Department of Defense
 Defense Logistics Agency – Defense Working Capital Fund
 Consolidated Statement of Budgetary Resources
 For the period ending September 30, 1998

BUDGETARY RESOURCES

Budgetary Authority	\$ 2,603,813,923.71
Unobligated Balances – Beginning of Period	(557,218,407.56)
Net Transfers Prior-Year Balance, Actual (+/-)	0.00
Spending Authority from Offsetting Collections	15,049,695,214.96
Adjustments	(3,722,251,532.78)
Total Budgetary Resources	<u>\$ 13,374,039,198.33</u>

STATUS OF BUDGETARY RESOURCES

Obligations Incurred	13,446,404,574.55
Unobligated Balances – Available	(72,365,376.22)
Unobligated Balances – Not Available	0.00
Total, Status of Budgetary Resources	<u>\$ 13,374,039,198.33</u>

OUTLAYS

Obligations Incurred	13,446,404,574.55
Less: Spending Authority from Offsetting Collections and Adjustments	(15,050,733,739.20)
Obligated Balance, Net – Beginning of Period	4,764,732,351.19
Obligated Balance Transferred, Net	(1,500,993.42)
Less: Obligated Balance, Net – End of Period	(4,572,350,333.38)
Total Outlays	<u>\$ (1,413,448,140.26)</u>

Additional information included in Note 19.

Principal Financial Statements

**Department of Defense
Defense Logistics Agency – Defense Working Capital Fund
Consolidated Statement of Financing
For the period ending September 30, 1998**

**OBLIGATIONS AND NONBUDGETARY
RESOURCES**

Obligations Incurred	\$ 13,446,404,574.55
Less: Spending Authority for Offsetting Collections and Adjustments	(15,050,559,154.14)
Donations not in Entities Budget	0.00
Financing Imputed for Cost Subsidies	400,003,866.00
Transfers-In/(Out)	142,838,058.76
Exchange Revenue Not in the Entity's Budget	0.43
Other	0.00
Total Obligations as Adjusted and Nonbudgetary Resources	\$ (1,061,312,654.40)

**RESOURCES THAT DO NOT FUND NET COST OF
OPERATIONS**

Change in Amount of Goods, Services, and Benefits Ordered but not Yet Received or Provided	315,660,312.97
Costs Capitalized on the Balance Sheet	131,698,849.20
Financing Sources That Fund Costs of Prior Periods	308,063,922.80
Other	(215,935,216.67)
Total Resources That Do not Fund Net Costs of Operations	\$ 539,487,868.30

COSTS THAT DO NOT REQUIRE RESOURCES

Depreciation and Amortization	83,193,300.01
Revaluation of Assets and Liabilities	0.00
Other	(10,527,600.32)
Total Costs That Do Not Require Resources	\$ 72,665,699.69

Financing Sources Yet to Be Provided	341,154,892.32
Net Costs of Operations	\$ (108,004,194.09)

Additional Information included in Note 20.

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Notes to the Principal Financial Statements

*Defense Logistics Agency – Defense Working
Capital Fund*

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Note 1. Summary of Significant Accounting Policies**A. Basis of Presentation**

These financial statements have been prepared to report the financial position and results of operations of the Defense Logistics Agency (DLA), as required by the Chief Financial Officers (CFO) Act of 1990 expanded by the Government Management Reform Act (GMRA) of 1994, and other appropriate legislation. The report has also been prepared to provide information with which Congress, agency managers, the public, and other interested parties can assess management performance stewardship. They have been prepared from the accounting records of DLA in accordance with the Federal Accounting Standards Advisory Board (FASAB), DoD Financial Management Regulations including Volume 6B, as adopted from the Office of Management and Budget (OMB) Bulletin No.97-01, "Form and Content of Agency Financial Statements." To the extent that guidance is not provided by one of these standards, DLA accounts for transactions in accordance with guidance promulgated by the General Accounting Office (GAO), Department of Treasury and Generally Accepted Accounting Principles (GAAP). These statements differ from the DLA financial reports prepared to monitor and control the use of budgetary resources.

B. Reporting Entity

The Defense Logistics Agency (DLA) is a combat support agency responsible for worldwide logistics support throughout the Department of Defense (DoD). The primary focus of DLA is to provide logistics support to the warfighter. In addition, DLA provides support to relief efforts during times of national emergency. Fiscal year 1998 represents the first year that DLA will prepare and provide Defense Working Capital Fund stand-alone financial statements as required by the CFO Act and the GMRA.

The accounts used to prepare the statements are classified as entity/nonentity. Entity accounts consist of resources that the agency has the authority to decide how to use, where management is legally obligated to use funds to meet entity obligations. Non-entity accounts are assets that are held by an entity but are not available for use in operations. The DLA organization has five active entity sub-organizations funded through the DWCF. These sub-organizations are referred to herein as activity groups and are as follows:

The Supply Management Activity Group (Supply) helps carry out this mission by procuring, managing and supplying over three billion consumable items to Military Departments, other DoD components, Federal agencies and selected foreign governments. The appropriation symbol is 97X4930.5C.

The Distribution Depot Activity Group (Distribution) receives, stores and distributes commodities, principal end items, and depot level repairables for the Military Departments and other DoD components, Federal agencies, and selected foreign governments. The appropriation symbol is 97X4930.5B.

The Defense Reutilization and Marketing Service Activity Group (DRMS) provides reutilization services which include receiving, classifying, segregating, demilitarizing, accounting for and reporting excess materiel for screening, lotting, merchandising, and sale. They also have the mission of hazardous property disposal and the economic recovery of precious metals from excess and surplus precious metal-bearing materiel. The appropriation symbol is 97X4930.5N.

The Information Services Activity Group provides information management support. The appropriation symbol is 97X4930.5F50.

The Defense Automated Printing Service Activity Group (DAPS) is responsible for document automation and printing within the Department of Defense, encompassing electronic conversion, retrieval, output and distribution of digital and hardcopy. The appropriation symbol is 97X4930.5G.

The accompanying audited financial statements account for all funds for which DLA is responsible except that information relative to classified assets, programs, and operations has been excluded from the statement or otherwise aggregated and reported in such a manner that is no longer classified. The audited financial statements are presented on the accrual basis of accounting as required by DoD accounting policies.

C. Budgets and Budgetary Accounting

The Department of Defense expanded the use of business-like financial management practices through the establishment of the Defense Business Operations Fund (DBOF) on October 1, 1991. On December 11, 1996, the DBOF became the Defense Working Capital Funds. The DWCF operate with financial principles that provide improved cost visibility and accountability to enhance business management and improve the decision making process. The DWCF is built on revolving fund principles previously used for industrial and commercial-type activities. The Department of Defense's Working Capital Fund includes industrial and commercial type transactions. These activities provide supplies and inventories to Department organizations on a commercial basis. Receipts derived from resale operations are normally available in their entirety for use without further congressional action.

Each Activity Group receives an annual operating budget (AOB) in unit cost terms. Unit Cost Resourcing provides the operating expense authority/cost authority for such items as salaries, non-labor expenses, and materiel within each activity. Cost authority or the amount "earned"

Notes to the Principal Statements

depends on the actual workload times the unit cost goals. Each Activity Group can also receive reimbursable authority for outputs/goods and services that are not contained in the unit cost goals. Host support for a tenant is an example.

Activity Groups may also receive a capital budget that provides the obligation authority for the purchase of equipment, minor construction, ADP and telecommunications, and software development.

D. Basis of Accounting

Transactions are recorded on an accrual basis and on a budgetary basis. Under the accrual method of accounting, revenues are recognized when earned and expenses are recognized when incurred, without regard to receipt or payment of cash. Budgetary accounting facilitates compliance with legal and internal constraints and controls over the use of Federal funds. All known DLA intrafund balances have been eliminated. All other intrafund balances attributable to DoD and Other Federal entities have been identified in Note 22.

E. Revenues and Other Financing Sources

Exchange revenue is recognized at the point the rendered service is completed and billed, or at the point inventory items are sold. Certain Distribution activity group revenues are recognized based on the actual workload for the period. These revenues may be billed up to two months after work is performed. These financial statements include an adjustment to accrue for these billings. Revenue is not earned for the DRMS activity groups reutilization, transfer, and donation programs.

F. Accounting for Intragovernmental Activities

DLA, as an agency of the Federal government, interacts with, and is dependent upon, other financial activities of the government as a whole. As a result, these financial statements do not reflect the results of all financial decisions applicable to DLA as though the agency were a stand-alone entity.

1. DLA's proportionate share of the public debt and related expenses of the Federal Government are not included in these financial statements because debt and related interest costs are not apportioned to Federal agencies. The DLA's financial statements therefore do not report any portion of the public debt or interest thereon, nor do the statements report the source of public financing whether from issuance of debt or tax revenues.
2. Financing for the construction of DoD facilities is obtained through budget appropriations from Congress. To the extent that this financing may have been ultimately obtained through the issuance of public debt, interest costs have not been capitalized because the Treasury Department does not allocate interest costs to the benefiting agencies.
3. DLA's civilian employees participate in the Civil Service Retirement System (CSRS) and Federal Employees Retirement System (FERS), while military personnel are covered by the Military Retirement System (MRS). Additionally, employees and personnel covered by FERS and MRS also have varying coverage under Social Security. DLA funds a portion of the civilian and military pensions. Reporting civilian pension benefits under CSRS and FERS retirement systems is the responsibility of the Office of Personnel Management. DLA recognizes an imputed expense for civilian employee pensions and other retirement benefits in the statement of net cost; and recognizes imputed revenue for the civilian employee pensions and other retirement benefits in the statement of changes in net position. DLA reports the assets, funded actuarial liability, and unfunded actuarial liability for the military personnel in the Military Retirement Trust Fund CFO report. DLA recognizes the actuarial liability for the military retirement health benefits in the DoD Agency-wide statements.
4. Most legal actions, other than contract claims, to which DLA may be a named party are covered by the provisions of the Federal Tort Claims Act and the provisions of Title 10, United States Code, Chapter 163, governing military claims. Either because payments under these statutes are limited to, amounts well below the threshold of materiality for claims payable from DLA's appropriations or because payments will be from the permanent, indefinite appropriation "Claims, Judgments, and Relief Acts" (the Judgment Fund), these legal actions should not materially affect DLA's operations or financial condition.

G. Funds with the U.S. Treasury and Cash

The DLA's fund resources are maintained in U.S. Treasury accounts. Fund Balances with Treasury represent the aggregate amount of an entity's accounts with Treasury for which the entity is authorized to make expenditures and pay liabilities. DWCF Activity Groups account for cash collections and disbursements. Beginning balances are not allocated to the Activity Groups. As a result, only the net of cash collections, disbursements, and transfers are presented on the Balance Sheet.

DLA currently reports cash balances as stated by the U.S. Treasury. A cumulative difference exists between the disbursements and collections reported by the U.S. Treasury and the disbursements and collections reported in DLA's accounting records and is referred to as undistributed. This cumulative difference exists because of in-transit disbursements, collections, and funding adjustments reported to and recorded by the Treasury but not yet reported to and recorded by DLA. For the Materiel Portion of Supply Management, these amounts are maintained in the trial balance in accounts called undistributed collections and disbursements. The cash balance is maintained at the consolidated level of reporting for Supply Management. The Fund Balance with Treasury is calculated by taking the amount reported by the U.S. Treasury and posting that as cash. Because of these adjustments, the Fund Balance with Treasury, Accounts Receivable, and Accounts Payable do not agree with the amounts shown in DLA's accounting records. These differences are disclosed as "undistributed" amounts in Note 5 for Accounts Receivable and Note 23 for Accounts Payable and are supported by the undistributed accounts on the trial balance.

Beginning in FY 99, in accordance with guidance issued on October 6, 1998 by OUSD(C), DLA will begin to report in its financial statements, cash balances as reported in its accounting records.

H. Foreign Currency

Gains and losses from foreign currency transactions are not recognized in the statement of operations. They are absorbed by budgetary transactions in which obligations are increased or decreased to reflect foreign currency fluctuations. There are no foreign currency translation adjustments.

I. Accounts Receivable

As presented in the balance sheet statement, accounts receivable includes accounts, claims and refunds receivable from other entities.

DLA has not established an allowance for uncollectible accounts because the majority of its revenues are the result of sales to other federal entities from which, due to the nature of the federal government, there are virtually no bad debts. Additionally, DLA has generally not experienced significant uncollectible accounts with its customers outside of the federal government.

As a result of the transfer of accounting and management responsibilities, DLA has had limited capability to reconcile these differences.

J. Loans Receivable

DLA Activity Groups do not lend money therefore does not have any loans receivable.

K. Inventories

Inventories are valued at (1) approximate historical cost in accordance with Statement of Federal Financial Accounting Standards Number 3, "Accounting for Inventory and related Property," and (2) Latest Acquisition Cost as required by DoD accounting policies. The latest acquisition cost method provides that the last representative invoice price shall be applied to all like units held, including units acquired through donation, non-monetary exchange, and return from end use or reutilization. Generally, the latest acquisition cost is determined by subtracting the appropriate surcharges from the standard cost to arrive at the price most recently paid for a carried item.

In addition to latest acquisition cost adjustments made to the valuation of inventory, DLA makes other inventory valuation adjustments due to physical gains or losses, accounting gains or losses, etc. These valuation adjustments, referred to as holding gains or losses, are realized when the price variance or valuation adjustment occurs and is reported on the Balance Sheet in a contra-inventory allowance account. These inventory adjustments are recognized in the Statement of Net Cost upon the sale or disposal of materiel. Prior to FY 1998, the holding gains or losses that resulted from price variances or valuation changes for inventory items were immediately recognized and reported in the Statement of Net Cost and included in the calculation of the cost of goods sold. Currently, DLA's accounting systems are unable to comply with the accounting guidance regarding inventory valuation, therefore these holding gains and losses are realized and recorded on the Balance Sheet and recognized in the Statement of Net Cost using an estimate. The net change in inventory for this new method of valuation is \$57,976,561.54.

Potential Reutilization Inventory (previously called potential excess inventory) is inventory in excess of approved force acquisition objectives and approved force retention stock objectives. Beginning in FY 1998, procedures accounting for potential excess inventory changed. These inventory items are written down to their net realizable value (3.4%) according to DoD guidance. The remaining portion is expensed and included in the calculation of unrealized holding period gains and losses.

Disposal property is classified and reported as "Other Entity Assets" in accordance with DoD reporting guidance. This property is not "primarily" held for sale, and therefore does not meet the definition of inventory for classification purposes.

Notes to the Principal Statements

DAPS inventories include operating materials and supplies and non-consumable items. These inventories are valued using the weighted-average method.

L. Investments in U.S. Government Securities

DLA Activity Groups do not invest in U.S. Government securities.

M. Property, Plant and Equipment

General Property, Plant and Equipment (PP&E) is valued at historical acquisition cost. All General PP&E, other than land, is depreciated in accordance with the Under Secretary of Defense (Comptroller) (USD(C)) policy memorandum dated March 26, 1998. General PP&E is reported at historical acquisition cost less any accumulated depreciation. The historical acquisition cost includes all the costs necessary to put the asset in place and into the form in which it will be used. The capital assets for DLA include such items as ADP equipment, materiel handling equipment, and software. Routine maintenance and repair costs are expensed when incurred. Depreciation for property and equipment is recorded on a straight-line basis.

General PP&E with an acquisition cost, book value, or when applicable, an estimated fair market value of \$100,000 and an estimated useful life of two years or more were capitalized. Prior to FY 96, General PP&E with an acquisition cost, book value, or when applicable, an estimated fair market value of \$15,000, \$25,000, and \$50,000 for FY 93, FY 94, and FY 95, respectively, and an estimated useful life of two years or more was capitalized.

The General Accounting Office (GAO) has determined that real property used by any DWCF activity, but under the jurisdiction of the Military Departments, represents an asset of the DWCF activity and such property should be reported on the financial statements as an Entity asset to show the full costs of all resources and assets used in operations. These amounts should be recorded at acquisition cost, or if unavailable, at fair market value. Documentation to support the recorded acquisition cost of many older properties is unavailable, and DoD believes it is not cost effective to obtain fair market value appraisals for many of these properties. These older properties would in all likelihood be fully depreciated, resulting in no impact to these financial statements.

The cost of Stewardship Assets (National Defense Property, Plant and Equipment, Heritage Assets and Stewardship Land) shall not be reported on the balance sheet beginning in FY 98. Any such previously reported costs shall be charged to the Net Position of the Entity, and the adjustment shall be shown as a "prior period adjustment." Other information on Stewardship Assets shall be reported in Supplemental Stewardship Reports. Multi-use Heritage Assets are treated as General PP&E for reporting and accounting purposes. Therefore, the acquisition costs of Multi-use Heritage Assets, and any capitalized renovations or improvements, shall be reported on the balance sheet and depreciated. Multi-use Heritage Assets are Heritage Assets that are predominantly for government operations.

N. Prepaid and Deferred Charges

Payments before the receipt of goods and services are recorded as advances at the time of prepayment and reported as an asset on the Statement of Financial Position. Expenses are recognized when the related goods and services are received.

O. Leases

DLA is committed to operating leases and rental agreements. Generally, these leases and agreements are for the rental of equipment, space and operating facilities. Payments under these operating leases are expensed as incurred.

DLA may also be party (as lessee) to a limited number of leases that meet the criteria of capital leases. However, DLA's accounting systems do not allow for the identification of these arrangements as capital leases. Therefore, payments under these arrangements are not capitalized, but expensed as incurred.

P. Contingencies

At any given time, DLA may be party to various legal and administrative claims and actions brought against it. In management's opinion, the resolution of these actions will not materially affect DLA operations or financial position. Therefore, no contingent liabilities have been recognized in the Statement of Financial Position.

Q. Accrued Leave

Civilian annual leave is accrued as earned, and accrued amounts are reduced as leave is taken. Unused annual leave is reported as a funded expense and the liability is reduced as leave is taken. The balances for annual civilian leave at the end of the fiscal year reflect current pay rates for the leave that is earned but not taken. Sick and other types of non-vested leave are expensed as taken. Each year, the balance in the accrued annual leave account is adjusted to reflect current pay rates. To the extent appropriations are not available to fund annual leave earned but not taken, funding will be obtained from future financing sources.

R. Equity

Equity consists of invested capital, capitalization of assets, cumulative results of operations, future funding requirements, and other equity balances. Cumulative results of operations for working capital funds represents the excess of revenues over expenses since fund inception, less refunds to customers and returns to the U.S. Treasury.

S. Aircraft/Ship Crashes

DLA does own any aircraft or ships; therefore this does not apply.

T. Treaties for Use of Foreign Bases

DLA has not entered into any treaties for the use of foreign bases.

U. Comparative Data

Comparative data for the prior year has not been presented because FY 98 is the first year for which financial statements are prepared using the OMB 97-01 prescribed format. In future years, comparative data will be presented in order to provide an understanding of changes in the financial position and operations of the DLA's reporting activities.

V. Undelivered Orders

DLA is obligated for goods and services, which have been ordered but not yet, received (undelivered orders) as of September 30, 1998.

Note 2. Fund Balances with Treasury

A. Entity Fund and account Balances

	<u>Revolving Funds</u>
Unobligated Balance Available:	
Available	912,465,263.27
Restricted	
Reserve for Anticipated Resources	-
Obligated (but not expensed)	(339,654,881.46)
Unfunded Contract Authority	-
Unused Borrowing Authority	-
Total Entity Treasury Balance	<u>572,810,381.81</u>

B. Non-Entity Fund and Account Balance

\$0.00

C. Canceled and Reopened Account Balances

The Fund Balance with the Treasury does not include any amounts for which the Department of the Treasury is willing to accept corrections to cancelled appropriation accounts, in accordance with SFFAS Number 1.

Notes to the Principal Statements

D. Other Information

Currently, a variance exists between the collections and disbursements reported by the U.S. Treasury and the collections and disbursements reported in DLA's accounting records and it is referred to as undistributed. Undistributed includes collections and disbursements by the U.S. Treasury that have not yet been posted in DLA's accounting records. DLA reports in its Balance Sheet, the cash balances as reported by the U.S. Treasury.

Note 3. Cash, Foreign Currency and Other Monetary Assets

DLA does not have any cash, foreign currency, or other monetary assets.

Note 4. Investments

DLA does not have any investments.

Note 5. Accounts Receivable, Net

	Gross Amount Due	Allowance for Estimated Uncollectibles	Net Amount Due
A. Entity Receivables			
Intragovernmental	770,452,055.37	N/A	770,452,055.37
With the Public	92,824,012.38	0.00	92,824,012.38
B. Non-Entity Receivables			
Intragovernmental	\$0.00	N/A	\$0.00
With the Public	0.00	0.00	0.00

C. Allowance method Used

DLA has not established an allowance for uncollectible accounts because the majority of its revenues are the result of sales to other federal entities from which, due to the nature of federal government, there are virtually no bad debts. Additionally, DLA has generally not experienced significant uncollectible accounts with its customers outside of the federal government.

D. Other Information

Currently, a variance exists between the cash reported by the U.S. Treasury and the cash reported in DLA's accounting records and it is referred to as undistributed cash. Undistributed cash includes cash collected by the U.S. Treasury that has not yet been posted in DLA's accounting records. At September 30, the U.S. Treasury reported \$166,733,518.74 more in collections than DLA posted in its accounting records. DLA reports in its Balance Sheet the accounts receivable amount in DLA's accounting records adjusted by the amount of undistributed collections reported by the U.S. Treasury. Accounts receivable, as reported in DLA's accounting records, is reconciled to Treasury's records in the following table:

	Accounts Receivable, Net (in DLA's records)	Undistributed Collections	Accounts Receivable, Gross
Entity Receivables			
Intragovernmental	888,511,807.70	(118,059,752.33)	770,452,055.37
Governmental	141,497,778.79	(48,673,766.41)	92,824,012.38
Total	1,030,009,586.49	166,733,518.74	863,276,067.75

Note 6. Other Assets**A. Other Entity Assets**

1. Intragovernmental	<u>0.00</u>
2. Other	
Payments to Contractors	188,926,578.93
Travel Advances	1,094,498.37
Equipment not in use	328,808,244.51
Items on Loan to other government	9,007,680.00
Items Due in to Storage	420,748.00
Reparable Inventory	19,881,232.00
Property Disposal Inventory	171,829,426.62
Other	<u>452,988.33</u>
Total Other	<u>720,421,396.76</u>

B. Other Information related to entity assets

Payments to contractors include amounts paid in advance to contractors and suppliers to finance production already accomplished or pursuant to production orders. These payments are recorded as progress payments at the time of prepayment and expensed when the goods or services are received. Travel advances are payments made to civilian employees for the purpose of business travel before the actual travel expense is incurred. Equipment Not in Use is equipment that is would normally be classified as Property, Plant and Equipment if it was currently being utilized. It includes items that are not currently being used because of

C. Other Non-entity Assets

1. Intragovernmental	<u>0.00</u>
2. Other	
Active Items in Hands of Contractors	69,280,000.00
Suspense Account	<u>14,026,946.80</u>
Total Other	<u>83,306,946.80</u>

D. Other Information related to non-entity assets

Active Items in Hands of Contractors include the value of ??? held by contractors for ???. The suspense accounts includes the value of ...

Note 7. Direct Loans and Loan Guarantees, Non-Federal Borrowers

DLA does not have and direct loans or loan guarantees.

Notes to the Principal Statements

Note 8. Inventory and Related Property

A. Inventory and Other Related Property

	Inventory Amount	Allowance for (Gains) losses	Inventory, Net	Valuation Method
1. Inventory Categories				
Held for Current Sale	8,282,471,941.28	(23,557,759.54)	8,306,029,700.82	LAC
Held in Reserve for Future Sale	1,385,233,410.37	-	1,385,233,410.37	LAC
Excess, Obsolete, and Unserviceable	34,418,802.00	-	34,418,802.00	NRV
Held for Repair	18,547,381.14	-	18,547,381.14	LAC
Total	9,720,671,534.79	(23,557,759.54)	9,744,229,294.33	

2. Restrictions on Inventory Use, Sale, or Disposition

Inventory Held in Reserve for Future Sale includes inventory held for research or reclassification and war reserve materiel. Inventory held for research or reclassification is held until its final disposition and is not available for immediate sale. War reserve materiel is inventory that is held for future use in case of conflict or other emergent need. War reserve materiel includes fuel and subsistence items and, at September 30, 1998, the value of the war reserve materiel held in reserve amounted to \$1,063,985,000.00.

3. Other Information

Inventory Classifications

Inventory Held for Sale includes the value of most supply system materiel that is in an issuable condition. It also includes the value of inventory that is in transit between storage locations or from suppliers. General ledger accounts are used to record the initial acceptance of inventory items when title has passed but the items have not been received and accepted into inventory.

Excess, Obsolete and Unserviceable inventory includes the value of three classifications of inventory. Excess inventory consists of items that are determined to be beyond economic and contingency retention stock levels and, as a result, are reported as potential reutilization or disposal materiel. Obsolete inventory includes items that are deemed obsolete and no longer needed due to changes in technology, laws, customs or operations. Unserviceable inventory include items that are not expected to survive repair after a technical evaluation is performed at a maintenance activity and damaged items that are not economical to repair. The value of all excess, obsolete and unserviceable inventory is written down to its net realizable value (3.4%) according to DoD guidance. The remaining portion is expensed and included in the calculation of unrealized holding period gains and losses.

Inventory Held For Repair includes the value of inventory items that are not in an issuable condition, but not beyond economical repair, and are awaiting repair before they are eligible for sale.

Inventory Adjustments

Significant adjustments occurred in all inventory related gain and loss accounts during the fiscal year. These adjustments were primarily the result of revised and improved program logic designed to reconcile SAMMS inventory-location balances with the Distribution Standard System (DSS) inventory-location balances. Additionally, physical inventories unrelated to SAMMS/DSS incompatibilities have been performed which resulted in adjustment transactions. The net result of all these transactions reflects improved accuracy in SAMMS inventory quantities and dollar values.

Other

Logistic transfer items are overvalued when standard prices are used as the recorded value. This situation is the result of NSN transfers to DLA from the Services for which either buy histories are unavailable or on which no recent buys have occurred.

Legend: Valuation Methods

LAC = Latest Acquisition Cost

SP = Standard Price

AC = Actual Cost

NRV = Net Realizable Value

O = Other

B. Operating Materials and Supplies (OM & S)

	OM&S Amount	Allowance for (Gains) Losses	OM&S, Net	Valuation Method
1. OM & S Categories				
Held for Use	11,894,062.85	0.00	11,894,062.85	O
Held for Reserve for Future use	0.00	0.00	0.00	—
Excess, obsolete, and Unserviceable	0.00	0.00	0.00	—
Total	11,894,062.85	0.00	11,894,062.85	

2. Restriction on Operating Materials and Supplies

There are currently no restrictions on the use, sale, or disposition of operating materials and supplies.

3. Other Information

Operating materials and supplies held for sale are valued using the weighted-average method.

Legend: Valuation Methods

LAC = Latest Acquisition Cost
SP = Standard Price
AC = Actual Cost

NRV = Net Realizable Value
O = Other

C. Stockpile Materials

DLA working capital fund does not own any stockpile materials.

D. Seized Property

DLA working capital fund does not own any seized property.

E. Forfeited Property, Net

DLA working capital fund does not own any forfeited property.

F. Goods Held Under Price Support and Stabilization Programs

DLA working capital fund does not own any goods held under price support and stabilization programs.

G. Recap of Inventory and Other Related Property

	Amount
Inventory, Net	9,744,229,294.33
Operating Materials and Supplies, Net	11,894,062.85
Stockpile Materials, Net	0.00
Seized, Property	0.00
Forfeited Property, Net	0.00
Total	9,756,123,357.18

Notes to the Principal Statements

Note. 9 General Property, Plant and Equipment, Net

	Depreciation Method	Service Life	Acquisition Value	Accumulated Depreciation	Net Book Value
A. Land	N/A	N/A	0.00	0.00	0.00
B. Structures, Facilities, L/H Improv.	SL	20	1,548,618,515.52	996,831,478.19	551,787,037.33
C. ADP Software	SL	5	15,147,952.71	13,044,752.67	2,103,200.04
D. Equipment	SL	10	499,984,447.37	365,258,559.47	134,725,887.90
E. Assets Under Capital Lease	SL	10	0.00	0.00	0.00
F. Construction in Progress	N/A	N/A	143,767,893.21	-	143,767,893.21
G. Other	SL	5 - 10	76,752.98	5,406.43	71,346.55
Total			<u>2,207,595,561.79</u>	<u>1,375,140,196.76</u>	<u>832,455,365.03</u>

Depreciation Methods Key

SL = Straight Line
OT = Other (describe)

H. Other Information

Certain assets were not capitalized as of September 30, 1998. They include a proprietary inventory management system (the Distribution Standard System), the DLA Headquarters' building and other miscellaneous corporate assets. DSS is comprised of computer hardware of \$57,160,000 and internally developed computer software of \$158,400,000. If all these assets were capitalized as of September 30, 1998 the total acquisition value of General Property, Plant and Equipment would have increased by \$367,186,702.00 to 2,574,782,263.79; total accumulated depreciation would have increased by \$94,527,393.54 to \$1,469,667,590.30; the total net book value of General Property, Plant and Equipment would have increased by \$272,659,308.46 to \$1,105,114,673.49.

Additionally, DLA has identified that a portion of the capital assets reported as construction in progress as of September 30, 1998 are misclassified. Analysis is currently being conducted by DFAS and the DLA Primary Field Level Activity (PLFA) Command sites to identify corrections needed. These changes will be made in fiscal year 1999.

Note 10. Debt

DLA working capital fund does not have any debt.

Note 11. Other Liabilities

A. Environmental Cleanup

There are no Environmental Cleanup Liabilities for DLA Working Capital Fund. Accrued Environmental Restoration liabilities, including Base Realignment and Closure (BRAC) cleanup activities, are budgeted with appropriated funds. Any environmental restoration or cleanup liabilities resulting from operations of the Defense Energy Support Center are captured in the year of occurrence and presented as accounts payable.

B. Other Liabilities

	Non-Current liabilities	Current Liabilities	Total
1. Intragovernmental			
Advances from others	0.00	133,691,208.34	133,691,208.34
Contingent Liabilities	0.00	0.00	0.00
Deferred Credits	0.00	0.00	0.00
Deposit Funds and Suspense Account Liabilities	0.00	14,026,946.80	14,026,946.80
Liability for Borrowings to be received	0.00	0.00	0.00
Liability for Subsidy Related to Undisbursed Loans	0.00	0.00	0.00

	Non-Current liabilities	Current Liabilities	Total
Other Liabilities	13,202,108.79	43,544,925.18	56,747,033.97
Resources Payable to Treasury	0.00	0.00	0.00
Total	13,202,108.79	191,263,080.32	204,465,189.11

2. With the Public

Accrued Funded Payroll and Benefits	0.00	122,748,609.54	122,748,609.54
Advances from Others	0.00	1,020,401.32	1,020,401.32
Contingent Liabilities	0.00	0.00	0.00
Deferred Credits	0.00	0.00	0.00
Deposit Funds and Suspense Account Liabilities	0.00	0.00	0.00
Other Liabilities	0.00	2,128,131.89	2,128,131.89
Total	0.00	125,897,142.75	125,897,142.75

Other Information

Intergovernmental advances from others include... Intergovernmental deposit funds and suspense accounts include... Intergovernmental other liabilities include...

Accrued funded payroll and benefits with the public includes \$xxx,xxx,xxx.xx of accrued payroll expense and \$xxx,xxx,xxx.xx of accrued funded leave expense. Advances from others with the public include ...Other liabilities with the liabilities includes ...

Other Liabilities Not Covered by Budgetary Resources

	Non-Current liabilities	Current Liabilities	Total
1. Intragovernmental			
Accounts Payable Canceled	0.00	0.00	0.00
Contingent Liabilities	0.00	0.00	0.00
Custodial Liability	0.00	0.00	0.00
Deferred Credits	0.00	0.00	0.00
Liability for Borrowings to be received	0.00	0.00	0.00
Other Actuarial Liabilities	0.00	0.00	0.00
Other Liabilities	0.00	0.00	0.00
Total	0.00	0.00	0.00
2. With the public			
Accounts Payable Canceled	0.00	0.00	0.00
Accrued Cleanup Costs	0.00	0.00	0.00
Accrued Unfunded Liabilities	0.00	0.00	0.00
Contingent Liabilities	0.00	0.00	0.00
Deferred Credits	0.00	0.00	0.00
Other Liabilities	0.00	209,487,000.00	209,487,000.00
Prior Liens Outstanding on Acquired Collateral	0.00	0.00	0.00
Total	0.00	209,487,000.00	209,487,000.00

Notes to the Principal Statements _____

Other Information

Other liabilities with the public that are not covered by budgetary resources include...

1

Note 12. Leases

DLA working capital fund does not have any operating or capital leases.

Note 13. Pensions and Other Actuarial Liabilities

Major Program Activities	Actuarial Present Value of Projected Plan Benefits	Assumed Interest Rate (%)	Assets Available to Pay Benefits	Unfunded Actuarial Liability
A. Pension and Health Benefits				
1. Military Retirement Pensions	\$0.00	0.00%	\$0.00	\$0.00
2. Military Retirement Health Benefits	0.00	0.00%	0.00	0.00
B. Insurance/ Annuity Programs				
1. FEHBP	93,846,132.00	0.00%	0.00	93,846,132.00
2. FEGLI	327,663.00	0.00%	0.00	327,663.00
3.	0.00	0.00%	0.00	0.00
Total	0.00		0.00	94,173,795.00
C. Other				
1. CSRS	96,136,849.00	0.00%	0.00	96,136,849.00
2. FERS	206,222.00	0.00%	0.00	206,222.00
3.	0.00	0.00%	0.00	0.00
Total	0.00		0.00	96,343,071.00
D. Total (Lines A+ B+ C)	190,516,866.00		\$0.00	190,516,866.00
E. Other Information				

The Department of Labor provides future workers' compensation figures. The liability for future workers' compensation (FWC) benefits includes the expected liability for death, disability, medical, and miscellaneous costs for approved compensation cases.

Note 14. Unexpended Appropriations

DLA working capital fund does not have any unexpended appropriations.

Note 15. Contingencies

At any given time, DLA may be party to various legal and administrative claims and actions brought against it. In management's opinion, the resolution of these actions will not materially affect DLA operations or financial position. Therefore, no contingent liabilities have been recognized in the Balance Sheet.

Notes to the Principal Statements

Note 16. Footnote disclosures related to the Statement of Net Cost

A. Suborganization Program Costs

Not applicable

B. Cost of National Defense PP&E

Not applicable

C. Cost of Stewardship Assets

Not applicable

D. Stewardship Assets Transferred

Not applicable

E. Exchange Revenue

Not applicable

F. Revenue and Expense Amounts for Military Foreign Sales (FMS) Program Procurements from Contractors

Not applicable

G. Benefit Program Expenses as of September 30, 1998

Not applicable

Note 17. Deferred Maintenance on Property, Plant and Equipment

A. Summary of Deferred Maintenance Amounts by Category of Property, Plant and Equipment As of September 30, 1998

PP&E Category:

1. General Property, Plant and Equipment	\$80,200,000.00
2. National Defense Property, Plant and Equipment	0.00
3. Heritage Assets	0.00
4. Stewardship Land	0.00
Total	\$0.00

B. General Property, Plant and Equipment Deferred Maintenance As of September 30, 1998

Property Type/ Major Class:

1. Personal Property	\$0.00
2. Real Property	
Buildings	\$61,200,000.00
Structures	19,000,000.00
Land	0.00
Total Real Property	0.00
Total	\$80,200,000.00

Other Information

DLA operates a number of distribution facilities throughout the world. During the fiscal year ending September 30, 1998 maintenance expense was recognized as incurred. However, maintenance completed during the FY 1998 was insufficient over the past several years and resulted in deferred maintenance.

Information on deferred maintenance is based on periodic inspections of these facilities. DLA has adopted the military standards and policies as outlined in the Department of the Army Pamphlet 420-6, Facilities Engineering Resources Management System, in the evaluation of facility conditions. The requirements, statements, and annual work plans outline in Pamphlet 420-6 are used by DLA in establishing funding levels and executing Real Property Maintenance Agreements. There have not been any material changes in the standards in recent years.

The following chart presents information on deferred maintenance on major categories of property, plant and equipment experiencing material amounts of deferred maintenance:

Property Type/ Major Class:	Method	Asset Condition (See Note 2)	Cost to Return Asset to Acceptable Condition (See Note 1)
Buildings	Condition Assessment Survey	TBD	TBD
Structures	Condition Assessment Survey	TBD	TBD

Note 1: Conditional Rating Scales:

Excellent, Good, Fair, Poor, Very Poor

Note 2: Acceptable condition is "fair"

**C. National Defense Property, Plant and Equipment Deferred Maintenance Table
As of September 30, 1998**

DLA working capital fund does not own any National Defense Property, Plant and Equipment, therefore does not have any deferred maintenance on equipment classified as such.

Note 18. Footnote Disclosures related to the Statement of Changes in Net Position

A. Prior Period Adjustments

Changes in Accounting Standards	107,595,623.65
Error and Omission in Prior Year	
Accounting	207,371,235.96
Other	0.00
Total	<u>314,966,859.61</u>

B. Other Information

Insert text.

Note 19. Disclosures Related to the Statement of Budgetary Resources

A. Net amount of Budgetary Resources Obligated for Undelivered Orders at the End of Period	<u>5,163,857,389.01</u>
B. Available Borrowing and Contract Authority at the End of Period	<u>2,877,046,749.86</u>
C. Other Information	

Insert text.

Notes to the Principal Statements

Note 20. Disclosures related to the Statement of Financing

Insert text.

Note 21. Disclosures related to the Statement of Custodial Activity

DLA working capital fund does not have any custodial activity.

Note 22. InterAgency Eliminations

A. DoD Eliminations of Seller Activity with other Federal Agencies Arrayed by DoD Entities	Treasury index (T.I.) or T.I. and Appropriation	Accounts Receivable with other Federal Entities	Revenue with other Federal Entities	Unearned Revenue from other Federal Entities
Department of the Army, General Funds	21	0.00	0.00	0.00
Department of the Navy, General Funds	17	0.00	0.00	0.00
Department of the Air Force, General Funds	57	0.00	0.00	0.00
Department of the Army, WCF	97X4930.01	218,125,978.45	2,673,109,281.59	36,662.86
Department of the Navy, WCF	97X4930.02	187,354,343.84	4,885,553,708.49	29,679.46
Department of the Air Force, WCF	97X4930.03	193,399,725.81	5,385,235,086.45	99,513.48
Defense Logistics Agency, WCF	97X4930.05xx	0.00	0.00	0.00
Defense Finance and Accounting Service, WCF	97X4930.05xx	0.00	0.00	0.00
Other Defense Organizations, General Funds	97-xxxx	12,964,698.38	62,753,194.21	0.00
Other Defense Organizations, WCF	97X4930.04 & 97X4930.05xx	45,592,737.35	359,563,692.16	5,237.55
DoD Military Retirement Trust Fund	97-8097	0.00	0.00	0.00
U.S. Army Corps of Engineers	96	3,410,943.45	6,343,643.24	0.00
Total		660,848,427.28	13,372,558,606.14	171,093.35

Notes to the Principal Statements

B. DoD Eliminations of Seller Activity Arrayed by other Federal Agencies	Treasury Index	DoD accounts Receivable Arrayed by Customer	DoD Revenue Arrayed by Customer	DoD Unearned Revenue by Customer
Executive Office of the President, Defense Security Assistance Agency	11	0.00	0.00	0.00
Department of Agriculture	12	27,027,469.44	29,954,304.11	0.00
Department of Commerce	13	412,877.50	1,791,526.27	0.00
Department of the Interior	14	2,252,667.71	3,106,308.15	0.00
Department of Justice	15	8,814,277.85	17,921,887.13	0.00
Department of Labor	16	3,837,953.82	8,820,382.07	0.00
Department of State	19	1,140,820.64	524,288.89	0.00
Department of the Treasury	20	371,732.65	1,727,150.12	0.00
Office of Personnel Management	24	9,795.48	4,183.08	0.00
Nuclear Regulatory Commission	31	599.00	0.00	0.00
Department of Veterans Affairs	36	2,207,301.10	1,963,989.61	0.00
General Service Administration	47	3,706,440.08	6,961,969.64	0.00
National Science Foundation	49	186,991.30	3,583,050.16	0.00
Federal Emergency Management Agency	58	1,325,214.18	66,993.33	0.00
Environmental Protection Agency	68	50,397.29	27,343.92	0.00
Department of Transportation	69	27,301,428.31	82,332,279.16	3,491.71
Agency for International Development	72	39,209.08	(91,885.79)	0.00
Small Business Administration	73	1,908.27	0.00	0.00
Department of Health and Human Services	75	5,374,244.76	1,984,938.68	0.00
National Aeronautics and Space Administration	80	3,926,588.80	15,687,444.86	0.00
Department of Housing and Urban Development	86	0.00	0.00	0.00
Department of Energy	89	569,153.34	2,757,788.14	0.00
Department of Education	91	74,315.15	89,509.29	0.00
Social Security Administration	28	0.00	0.00	0.00
Unidentifiable Federal Agency Entity	00	(13,457,665.51)	25,342,000.00	0.00
Miscellaneous Identifiable Federal Agencies (see note 1)	00	7,941,040.93	38,723,165.69	0.00
Total		83,114,761.17	243,278,616.51	3,491.71

Note 1: Not required to complete CFO Statements

Notes to the Principal Statements

Note 23. Other Disclosures

Currently, a variance exists between the disbursements reported by the U.S. Treasury and the disbursements reported in DLA's accounting records and it is referred to as undistributed. Undistributed includes disbursements by the U.S. Treasury that has not yet been posted in DLA's accounting records. At September 30, the U.S. Treasury reported \$897,078,817.14 more in disbursements than DLA posted in its accounting records. DLA reports in its Balance Sheet, the accounts payable amount in DLA's accounting records adjusted by the amount of undistributed disbursements. Accounts payable, as reported in DLA's accounting records with undistributed disbursements is shown in the following table:

	Accounts Payables (in DLA's records)	Undistributed Disbursements	Accounts Payable
Entity Payables			
Intragovernmental	646,966,565.18	(206,093,678.02)	440,872,887.16
With the Public	1,469,518,875.27	(690,985,139.12)	778,533,736.15
Total	2,116,485,440.45	897,985,139.12	1,219,406,623.31

Disclaimer of DAPS financial position

Because of financial information system problems and financial statement compilation problems, DLA believes that the Defense Automated Printing Service (DAPS) financial statements are not completely representative of the DAPS financial position. DLA management does not believe that this will materially affect the fiscal year 1998 DLA Working Capital Fund Chief Financial Officer Annual Financial Statement. At September 30, 1998, DAPS assets represented less than 1% of the total DLA combined assets, DAPS revenues represented approximately 2.4% of total DLA combined revenues and DAPS expenses represented approximately 2.6% of total DLA combined expenses.

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Required Supplemental Stewardship Information

*Defense Logistics Agency – Defense Working
Capital Fund*

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National Defense Property, Plant and Equipment

National defense property, plant and equipment is the property, plant, and equipment (PP&E) components of weapons systems and support PP&E used by the military departments in the performance of military missions. DLA does not own any PP&E that would be classified as national defense property, plant and equipment.

Stewardship Land

Stewardship land is land other than that acquired for or in the connection with general property, plant, and equipment. It may include land that was previously identified as public domain land or land that was donated to the federal government. DLA is not permitted by law to own land, therefore does not own any land that would be classified as stewardship Land.

Heritage Assets

Heritage assets are property, plant, and equipment of historical, natural, cultural, educational, artistic or architectural significance. DLA does not own any assets that would be classified as heritage assets.

Non-Federal Physical Property

Non-federal physical property refers to those expenses incurred by the Department of Defense for the purchase, the construction, or the major renovation of physical property owned by state and local governments, including major additions, alterations and replacements; the purchase of major equipment; and the purchase or improvement of other physical assets. Grants for maintenance and operations are not considered investments. DLA does not own any property that would be classified as Non-Federal Physical Property.

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Required Supplemental Information

*Defense Logistics Agency – Defense Working
Capital Fund*

Required Supplemental Information

Department of Defense
Defense Logistics Agency – Defense Working Capital Fund
Disaggregation Statement of Budgetary Resources
For the period ending September 30, 1998

	<u>Supply Management</u>	<u>Distribution Depots</u>	<u>Reutilization & Marketing Service</u>
BUDGETARY RESOURCES			
Budgetary Authority	\$ 2,430,547,360.12	\$ 158,601,563.59	\$ 0.00
Unobligated Balances – Beginning of Period	(601,332,894.04)	0.00	0.00
Net Transfers Prior Year Balance, Actual (+/-)	0.00	0.00	0.00
Spending Authority from Offsetting Collections	(12,550,016,185.46)	1,370,698,436.41	577,891,112.09
Adjustments	(3,518,630,420.69)	0.00	(203,621,112.09)
Total Budgetary Resources	<u>\$ 10,860,610,230.85</u>	<u>\$ 1,529,300,000.00</u>	<u>\$ 374,270,000.00</u>
STATUS OF BUDGETARY RESOURCES			
Obligations Incurred	10,851,075,618.48	1,489,434,030.14	361,034,560.11
Unobligated Balances – Available	9,534,612.37	39,865,969.86	13,235,439.89
Unobligated Balances – Not Available	0.00	0.00	0.00
Total, Status of Budgetary Resources	<u>\$ 10,860,610,230.85</u>	<u>\$ 1,529,300,000.00</u>	<u>\$ 374,270,000.00</u>
OUTLAYS			
Obligations Incurred	10,851,075,618.48	1,489,434,030.14	361,034,560.11
Less: Spending Authority from Offsetting Collections and Adjustments	(12,551,054,709.70)	(1,370,698,436.41)	(577,891,112.09)
Obligated Balance, Net – Beginning of Period	4,522,834,665.03	200,349,883.05	103,444,841.26
Obligated Balance Transferred, Net	0.00	0.00	0.00
Less: Obligated Balance, Net – End of Period	(4,150,652,593.97)	(134,611,075.81)	(123,933,184.32)
Total Outlays	<u>\$ (1,327,797,020.16)</u>	<u>\$ 184,474,400.97</u>	<u>\$ (237,344,895.04)</u>

<u>Information Services</u>	<u>Automated Printing Service</u>	<u>Combined</u>
\$ 0.00	\$ 14,665,000.00	\$ 2,603,813,923.71
42,603,493.09	1,500,993.42	(557,218,407.56)
0.00	0.00	0.00
108,051,882.19	443,037,598.81	15,049,695,214.96
0.00	0.00	(3,722,251,532.78)
<u>\$ 150,655,375.25</u>	<u>\$ 459,203,592.23</u>	<u>\$ 13,374,039,198.33</u>
111,269,395.40	633,590,970.42	13,446,404,574.55
39,385,979.85	(174,387,378.19)	(72,365,376.22)
0.00	0.00	0.00
<u>\$ 150,655,375.25</u>	<u>\$ 459,203,592.23</u>	<u>\$ 13,374,039,198.33</u>
111,269,395.40	633,590,970.42	13,446,404,574.55
(108,051,882.19)	(443,037,598.81)	(15,050,733,739.20)
(44,273,279.70)	(17,623,758.45)	4,764,732,351.19
0.00	(1,500,993.42)	(1,500,993.42)
32,234,433.16	(195,387,912.44)	(4,572,350,333.38)
<u>\$ (8,821,333.33)</u>	<u>\$ (23,959,292.70)</u>	<u>\$ (1,413,448,140.26)</u>

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Other Accompanying Information

*Defense Logistics Agency – Defense Working
Capital Fund*

Other Accompanying Information

Department of Defense Defense Logistics Agency – Defense Working Capital Fund Consolidating Balance Sheet As of September 30, 1998

	Supply Management	Distribution Depots	Reutilization & Marketing Service
ASSETS			
Entity Assets			
Intragovernmental			
Fund Balance With Treasury (Note 2)	\$ 504,783,020.16	\$ (184,474,400.97)	\$ 237,344,895.04
Investments, Net (Note 4)	0.00	0.00	0.00
Accounts Receivable, Net (Note 5)	535,900,810.37	462,184,686.98	37,079,220.15
Other Assets (Note 6)	0.00	0.00	0.00
Total Intragovernmental	<u>1,040,683,830.53</u>	<u>277,710,286.01</u>	<u>274,424,115.19</u>
Investments (Note 4)	0.00	0.00	0.00
Accounts Receivable, Net (Note 5)	56,301,262.02	1,086,275.28	34,892,053.89
Loans Receivable and Related Foreclosed Property, Net (Note 7)	0.00	0.00	0.00
Cash and Other Monetary Assets (Note 3)	0.00	0.00	0.00
Inventory and Related Property, Net (Note 8)	9,744,229,294.33	0.00	0.00
General Property, Plant and Equipment (Note 9)	179,696,314.11	496,642,694.07	116,725,514.44
Stewardship Assets (National Defense PP&E)	See Stewardship Statement		
Other Assets (Note 6)	474,441,032.98	62,340,836.03	178,562,604.28
Total Entity Assets	<u>11,495,351,733.97</u>	<u>837,780,091.39</u>	<u>604,604,287.80</u>
Non-Entity Assets			
Intragovernmental			
Fund Balance With Treasury (Note 2)	0.00	0.00	0.00
Accounts Receivable, Net (Note 5)	0.00	0.00	0.00
Other Assets (Note 6)	0.00	0.00	0.00
Total Intragovernmental	<u>0.00</u>	<u>0.00</u>	<u>0.00</u>
Accounts Receivable, Net (Note 5)	0.00	0.00	0.00
Cash and Other Monetary Assets (Note 3)	0.00	0.00	0.00
Other Assets (Note 6)	69,280,000.00	0.00	14,026,946.80
Total Non-Entity Assets	<u>69,280,000.00</u>	<u>0.00</u>	<u>14,026,946.80</u>
Total Assets	<u>\$ 11,564,631,733.97</u>	<u>\$ 837,780,091.39</u>	<u>\$ 618,631,234.60</u>

Other Accompanying Information

Information Services	Automated Printing Service	Combined	Eliminations	Adjustments	Consolidat
8,821,333.33 \$	6,335,534.25 \$	572,810,381.81 \$	0.00 \$	0.00 \$	572,810,381.81 \$
0.00	0.00	0.00	0.00	0.00	0.00
12,771,333.93	77,612,926.54	1,125,548,977.97	0.00	0.00	1,125,548,977.97
0.00	0.00	0.00	0.00	0.00	0.00
21,592,667.26	83,948,460.79	1,698,359,359.78	0.00	0.00	1,698,359,359.78
0.00	0.00	0.00	0.00	0.00	0.00
77.70	2,093,117.27	94,372,786.16	0.00	0.00	94,372,786.16
0.00	0.00	0.00	0.00	0.00	0.00
0.00	0.00	0.00	0.00	0.00	0.00
0.00	11,894,062.85	9,756,123,357.18	0.00	0.00	9,756,123,357.18
7,740,179.72	31,650,662.69	832,455,365.03	0.00	0.00	832,455,365.03
See Stewardship Statement					
5,076,923.47	0.00	720,421,396.76	0.00	0.00	720,421,396.76
34,409,848.15	129,586,303.60	13,101,732,264.91	0.00	0.00	13,101,732,264.91
0.00	0.00	0.00	0.00	0.00	0.00
0.00	0.00	0.00	0.00	0.00	0.00
0.00	0.00	0.00	0.00	0.00	0.00
0.00	0.00	0.00	0.00	0.00	0.00
0.00	0.00	0.00	0.00	0.00	0.00
0.00	0.00	83,306,946.80	0.00	0.00	83,306,946.80
0.00	0.00	83,306,946.80	0.00	0.00	83,306,946.80
34,409,848.15 \$	129,586,303.60 \$	13,185,039,211.71 \$	0.00 \$	0.00 \$	13,185,039,211.71 \$

Other Accompanying Information

Department of Defense Defense Logistics Agency - Defense Working Capital Fund Consolidating Balance Sheet As of September 30, 1998

	Supply Management	Distribution Depots	Reutilization & Marketing Service
LIABILITIES			
Liabilities Covered by Budgetary Resources			
Intragovernmental Liabilities			
Accounts Payable	\$ 475,104,150.43	\$ 190,599,657.07	\$ 58,563,886.29
Environmental Cleanup (Note 11)	0.00	0.00	0.00
Debt (Note 10)	0.00	0.00	0.00
Other Liabilities (Note 11, 12, and 15)	133,431,935.84	0.00	70,773,980.77
Total Intragovernmental	608,536,086.27	190,599,657.07	129,337,867.06
Accounts Payable	439,469,672.30	243,598,750.29	55,623,701.81
Liabilities for Loan Guarantees	0.00	0.00	0.00
Military Retirement Benefits & Other Employment Related Actuarial Liabilities (Note 13)	0.00	0.00	0.00
Environmental Cleanup (Note 11)	0.00	0.00	0.00
Other Liabilities (Note 11)	63,884,908.74	38,554,604.42	10,971,990.37
Total Liabilities Covered by Budgetary Resources	1,111,890,667.31	472,753,011.78	195,933,559.24
Liabilities not Covered by Budgetary Resources			
Intragovernmental Liabilities			
Accounts Payable	0.00	0.00	0.00
Debt (Note 10)	0.00	0.00	0.00
Environmental Cleanup (Note 11)	0.00	0.00	0.00
Other Liabilities (Note 11, 12, and 15)	0.00	0.00	0.00
Total Intragovernmental	0.00	0.00	0.00
Accounts Payable	0.00	0.00	0.00
Debt (Note 10)	0.00	0.00	0.00
Military Retirement Benefits & Other Employment Related Actuarial Liabilities (Note 13)	0.00	0.00	0.00
Environmental Cleanup (Note 11)	0.00	0.00	0.00
Other Liabilities (Note 11, 12, and 15)	0.00	0.00	0.00
Total Liabilities not Covered by Budgetary	0.00	0.00	0.00
Total Liabilities	1,111,890,667.31	472,753,011.78	195,933,559.24
NET POSITION			
Unexpended Appropriations (Note 14)	0.00	0.00	0.00
Cumulative Results of Operations	10,452,741,066.66	365,027,079.61	422,697,675.36
Total Net Position	10,452,741,066.66	365,027,079.61	422,697,675.36
Total Liabilities and Net Position	\$ 11,564,631,733.97	\$ 837,780,091.39	\$ 618,631,234.60

Other Accompanying Information

Information Services	Automated Printing Service	Combined	Eliminations	Adjustments	Consolidate
\$ 6,387,807.79	\$ 47,055,375.33	\$ 777,710,876.91	\$ 0.00	\$ 0.00	\$ 777,710,876.91
0.00	0.00	0.00	0.00	0.00	0.00
0.00	0.00	0.00	0.00	0.00	0.00
0.00	(105,971,386.93)	98,234,529.68	0.00	0.00	98,234,529.68
6,387,807.79	(58,916,011.60)	875,945,406.59	0.00	0.00	875,945,406.59
14,467,471.71	151,412,506.10	904,572,102.21	0.00	0.00	904,572,102.21
0.00	0.00	0.00	0.00	0.00	0.00
0.00	0.00	0.00	0.00	0.00	0.00
0.00	0.00	0.00	0.00	0.00	0.00
6,528,550.50	5,957,088.72	125,897,142.75	0.00	0.00	125,897,142.75
27,383,830.00	98,453,583.22	1,906,414,651.55	0.00	0.00	1,906,414,651.55
0.00	0.00	0.00	0.00	0.00	0.00
0.00	0.00	0.00	0.00	0.00	0.00
0.00	0.00	0.00	0.00	0.00	0.00
0.00	0.00	0.00	0.00	0.00	0.00
0.00	0.00	0.00	0.00	0.00	0.00
0.00	0.00	0.00	0.00	0.00	0.00
0.00	0.00	0.00	0.00	0.00	0.00
0.00	0.00	0.00	0.00	190,516,866.00	190,516,866.00
0.00	0.00	0.00	0.00	0.00	0.00
0.00	0.00	0.00	0.00	209,487,000.00	209,487,000.00
0.00	0.00	0.00	0.00	400,003,866.00	400,003,866.00
27,383,830.00	98,453,583.22	1,906,414,651.55	0.00	400,003,866.00	2,306,418,517.55
0.00	0.00	0.00	0.00	0.00	0.00
7,026,018.15	31,132,720.38	11,278,624,560.16	0.00	(400,003,866.00)	10,878,620,694.16
7,026,018.15	31,132,720.38	11,278,624,560.16	0.00	(400,003,866.00)	10,878,620,694.16
\$ 34,409,848.15	\$ 129,586,303.60	\$ 13,185,039,211.71	\$ 0.00	\$ 0.00	\$ 13,185,039,211.71

Other Accompanying Information

Appropriations, Funds, and Accounts Included in Financial Statements

The following table lists all appropriation, funds, and accounts included in the financial statements for the year ended September 30, 1998:

Reporting Entity	Entity Sub-Organization	Fund/Account	Subhead
Defense Logistics Agency Working Capital Fund		97X4930.05	-
	<u>Active</u>		
	Supply Management	97X4930.05	C
	Distribution Depots	97X4930.05	B
	Defense Reutilization and Marketing Services(DRMS)	97X4930.05	N
	Information Services	97X4930.05	F5
	Defense Automated Printing Service (DAPS)	97X4930.05	G
	<u>Inactive</u>		
	Industrial Plant Equipment (IPE) ⁽¹⁾	97X4930.05	M
	Clothing Factory ⁽²⁾	97X4930.05	N

(1) The Industrial Plant Equipment sub-organization was consolidated with the Supply Management sub-organization in January 1992. Any remaining balances and activity through September 30, 1998 have been consolidated into the Supply Management sub-organization financial statements. Financial activity associated with contracts let before IPE's consolidation into the Supply Management sub-organization is expected to continue for years. All residual balances in the IPE sub-organization will be closed when these contracts have been settled.

(2) Effective September 30, 1994, the Clothing Factory sub-organization was closed under the Defense Base Realignment and Closure Act. At that date all of its operations were discontinued, except for the Flag and Embroidery operation which was transferred to the Clothing and Textiles operation of the Defense Supply Center Philadelphia. Any remaining balances through September 30, 1998 have been consolidated into the Supply Management sub-organization financial statements.



INSPECTOR GENERAL
DEPARTMENT OF DEFENSE
400 ARMY NAVY DRIVE
ARLINGTON, VIRGINIA 22202

March 1, 1999

MEMORANDUM FOR UNDER SECRETARY OF DEFENSE (COMPTROLLER) AND
CHIEF FINANCIAL OFFICER
DIRECTOR, DEFENSE LOGISTICS AGENCY

SUBJECT: Independent Auditor's Report on the Defense Logistics Agency
Working Capital Fund Financial Statements for FY 1998
(Project No. 9FJ-2005)

The Chief Financial Officers Act of 1990, as amended by the Federal Financial Management Act of 1994, requires financial statement audits by the Inspectors General and prescribes the responsibilities of management and the auditors for the financial statements, internal controls, and compliance with laws and regulations. We attempted to audit the FY 1998 Defense Logistics Agency (DLA) Working Capital Fund financial statements. The DLA prepared the financial statements based on information compiled by the Defense Finance and Accounting Service (DFAS) Columbus Center, Columbus, Ohio. Both DLA and DFAS are responsible for establishing and maintaining adequate internal controls and for complying with laws and regulations applicable to financial reporting. The Office of Management and Budget (OMB) designated the DLA Working Capital Fund as one of the DoD organizations required to prepare audited financial statements.

Disclaimer of Opinion. DLA and DFAS were not able to correct previously reported material deficiencies in inventory sampling and the Fund Balance with Treasury and Property, Plant, and Equipment accounts. These problems materially affected the information in the DLA FY 1998 financial statements. Although DLA and DFAS were taking action to correct the problems, their actions were not completed in FY 1998. Additionally, the process for providing information to us to audit was inefficient and was affected by the ability of DoD to publish guidance on the form and content of the financial statements in a timely manner. Therefore, we only performed sufficient work to determine the status of previously reported problems. We also performed limited tests of the internal controls and compliance with laws and regulations. These tests identified additional details about some of the significant problems that hampered DLA and DFAS from preparing reliable financial statements. As a result, we do not express an opinion on the FY 1998 financial statements of the DLA Working Capital Fund. The information provided contains our reasons for disclaimer and is based on our audit of previous versions of these financial statements. Some numbers may have changed; however, the concerns expressed also relate to the version of the financial statements contained herein.

Internal Controls. We performed a limited review of internal controls to determine whether they were effective. Internal controls consist of five components identified as follows: the control environment, risk assessment, control activities, information and communication, and monitoring. Effective implementation of these controls provides reasonable assurance that accounting data are accumulated, recorded, and reported properly by management and that assets are safeguarded. Our review of internal controls did not disclose all internal control weaknesses that exist. We identified the following major internal control weaknesses:

- DLA and DFAS did not have the systems and processes in place to produce reliable and timely financial statements.

- DLA did not implement a sound statistical sampling plan to measure the dollar accuracy of the reported inventory stored at the distribution depot.
- DLA used an inadequate methodology to estimate the historic cost of ending inventories.
- DLA may not have reported all existing and newly purchased capital assets as Property, Plant, and Equipment on the financial statements.
- The DFAS Columbus Center, Columbus, Ohio, did not reconcile DLA cumulative cash accounts (over \$1 billion were undistributed collections and disbursements) to the Department of Treasury.

Compliance With Laws and Regulations. We performed a limited assessment of compliance with laws and regulations related to the FY 1998 DLA Working Capital Fund Financial Statements. Noncompliance with laws and regulations is a reportable condition if the noncompliance could result in material misstatements in the financial statements or if the sensitivity of the matter would cause a reasonable person to perceive the noncompliance to be significant. Accounting systems and internal controls did not completely or accurately disclose the financial condition of the DLA Working Capital Fund as required by Title 31, United States Code. DoD accounting policies did not always comply with OMB Bulletin No. 97-01, "Form and Content of Agency Financial Statements," October 16, 1996, as amended November 20, 1998, in areas such as valuation and presentation of inventory.

Under the Federal Financial Management Improvement Act of 1996 and OMB Bulletin No. 98-08, "Audit Requirements for Federal Financial Statements," August 24, 1998, as amended January 25, 1999, DLA and DFAS disclosed that their financial management and feeder systems did not comply with Federal financial management system requirements, applicable Federal accounting standards, and the U.S. Government Standard General Ledger at the transaction level. However, DLA did not disclose in its annual assurance statement or management representation letter the extent to which non-compliant systems and other significant control weaknesses prevented the agency from preparing reliable financial statements.

Additional Reports. This is the first in a series of reports related to the FY 1998 Financial Statements of the DLA Working Capital Fund. This report briefly summarizes the major deficiencies affecting DLA. Additional reports will discuss internal controls and compliance with laws and regulations in more detail.



David K. Steensma
Deputy Assistant Inspector General
for Auditing

Notes to the Principal Financial Statements

*Defense Logistics Agency – Defense Working
Capital Fund*

Audit Team Members

The Finance and Accounting Directorate, Office of the Assistant Inspector General for Auditing, DoD, produced this report.

F. Jay Lane
Salvatore D. Guli
James L. Kornides
Tim F. Soltis
Curt W. Malthouse
Kevin C. Currier
Terry D. Holdren
Tony C. Hans
Mark Starinsky
Scott K. Miller
P. Doug Johnston